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FEDERAL TAXATION



SMITH • RAABE • MALONEY

TAXATION OF BUSINESS ENTITIES

2011 EDITION

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H&R BLOCK At Home

2009 Tax Rate Schedules

Single—Schedule X

If taxable income is: Over—	But not over—	The tax is:	of the amount over—
$ 0	$ 8,350	.....10%	$ 0
8,350	33,950	$ 835.00 + 15%	8,350
33,950	82,250	4,675.00 + 25%	33,950
82,250	171,550	16,750.00 + 28%	82,250
171,550	372,950	41,754.00 + 33%	171,550
372,950	.....	108,216.00 + 35%	372,950

Head of household—Schedule Z

If taxable income is: Over—	But not over—	The tax is:	of the amount over—
$ 0	$ 11,950	.....10%	$ 0
11,950	45,500	$ 1,195.00 + 15%	11,950
45,500	117,450	6,227.50 + 25%	45,500
117,450	190,200	24,215.00 + 28%	117,450
190,200	372,950	44,585.00 + 33%	190,200
372,950	.....	104,892.50 + 35%	372,950

Married filing jointly or Qualifying widow(er)—Schedule Y–1

If taxable income is: Over—	But not over—	The tax is:	of the amount over—
$ 0	$ 16,700	.....10%	$ 0
16,700	67,900	$ 1,670.00 + 15%	16,700
67,900	137,050	9,350.00 + 25%	67,900
137,050	208,850	26,637.50 + 28%	137,050
208,850	372,950	46,741.50 + 33%	208,850
372,950	.....	100,894.50 + 35%	372,950

Married filing separately—Schedule Y–2

If taxable income is: Over—	But not over—	The tax is:	of the amount over—
$ 0	$ 8,350	.....10%	$ 0
8,350	33,950	$ 835.00 + 15%	8,350
33,950	68,525	4,675.00 + 25%	33,950
68,525	104,425	13,318.75 + 28%	68,525
104,425	186,475	23,370.75 + 33%	104,425
186,475	.....	50,447.25 + 35%	186,475

2010 Tax Rate Schedules

Single—Schedule X

If taxable income is: Over—	But not over—	The tax is:	of the amount over—
$ 0	$ 8,375	.....10%	$ 0
8,375	34,000	$ 837.50 + 15%	8,375
34,000	82,400	4,681.25 + 25%	34,000
82,400	171,850	16,781.25 + 28%	82,400
171,850	373,650	41,827.25 + 33%	171,850
373,650	.....	108,421.25 + 35%	373,650

Head of household—Schedule Z

If taxable income is: Over—	But not over—	The tax is:	of the amount over—
$ 0	$ 11,950	.....10%	$ 0
11,950	45,550	$ 1,195.00 + 15%	11,950
45,550	117,650	6,235.00 + 25%	45,550
117,650	190,550	24,260.00 + 28%	117,650
190,550	373,650	44,672.00 + 33%	190,550
373,650	.....	105,095.00 + 35%	373,650

Married filing jointly or Qualifying widow(er)—Schedule Y–1

If taxable income is: Over—	But not over—	The tax is:	of the amount over—
$ 0	$ 16,750	.....10%	$ 0
16,750	68,000	$ 1,675.00 + 15%	16,750
68,000	137,300	9,362.50 + 25%	68,000
137,300	209,250	26,687.50 + 28%	137,300
209,250	373,650	46,833.50 + 33%	209,250
373,650	.....	101,085.50 + 35%	373,650

Married filing separately—Schedule Y–2

If taxable income is: Over—	But not over—	The tax is:	of the amount over—
$ 0	$ 8,375	.....10%	$ 0
8,375	34,000	$ 837.50 + 15%	8,375
34,000	68,650	4,681.25 + 25%	34,000
68,650	104,625	13,343.75 + 28%	68,650
104,625	186,825	23,416.75 + 33%	104,625
186,825	.....	50,542.75 + 35%	186,825

Basic Standard Deduction Amounts

Filing Status	Standard Deduction Amount 2009	2010
Single	$ 5,700	$ 5,700
Married, filing jointly	11,400	11,400
Surviving spouse	11,400	11,400
Head of household	8,350	8,400
Married, filing separately	5,700	5,700

Amount of Each Additional Standard Deduction

Filing Status	2009	2010
Single	$1,400	$1,400
Married, filing jointly	1,100	1,100
Surviving spouse	1,100	1,100
Head of household	1,400	1,400
Married, filing separately	1,100	1,100

Personal and Dependency Exemption

2009	2010
$3,650	$3,650

Income Tax Rates—Corporations

Taxable Income	Tax Rate
Not over $50,000	15%
Over $50,000 but not over $75,000	25%
Over $75,000 but not over $100,000	34%
Over $100,000 but not over $335,000	39%*
Over $335,000 but not over $10,000,000	34%
Over $10,000,000 but not over $15,000,000	35%
Over $15,000,000 but not over $18,333,333	38%**
Over $18,333,333	35%

*Five percent of this rate represents a phaseout of the benefits of the lower tax rates on the first $75,000 of taxable income.

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SOUTH-WESTERN
FEDERAL TAXATION

TAXATION OF BUSINESS ENTITIES 2011 EDITION

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Preface

To The Student

SOUTH-WESTERN CENGAGE Learning

THE LEADERSHIP YOU TRUST • THE INNOVATION YOU EXPECT • THE SERVICE YOU DESERVE

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THE BIG PICTURE **Tax Solutions for the Real World**

GOING INTERNATIONAL

VoiceCo, a domestic corporation, designs, manufactures, and sells specialty microphones for use in theaters. All of its activities take place in Florida, although it ships products to customers all over the United States. When it receives inquiries about its products from foreign customers, VoiceCo decides to test the foreign market and places ads in foreign trade journals. Soon, it is taking orders from foreign customers.

VoiceCo is concerned about its potential foreign income tax exposure. Although it has no assets or employees in the foreign jurisdictions, it now is involved in international commerce. Is VoiceCo subject to income taxes in foreign countries? Must it pay U.S. income taxes on the profits from its foreign sales? What if VoiceCo pays taxes to other countries? Does it receive any benefit from these payments on its U.S. tax return?

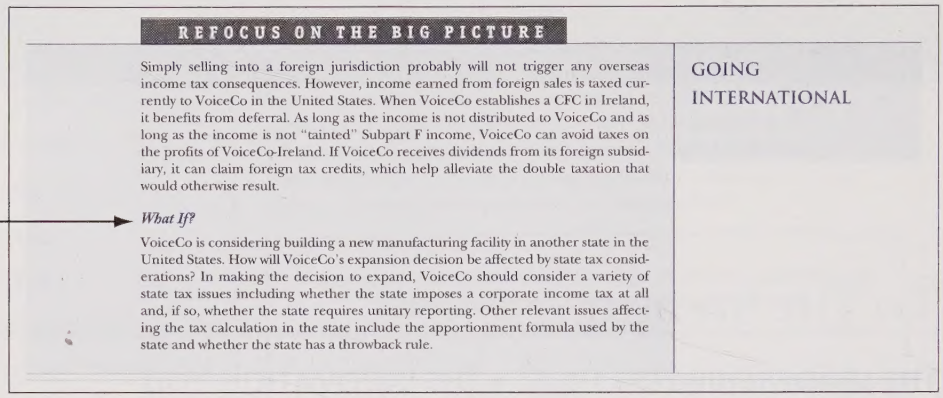
Suppose that VoiceCo establishes a manufacturing plant in Ireland to meet the European demand for its products. VoiceCo incorporates the Irish operation as a controlled foreign corporation (CFC) named VoiceCo-Ireland. So long as VoiceCo-Ireland does not distribute profits to VoiceCo, will the profits escape U.S. taxation? What are the consequences to VoiceCo of being the owner of the CFC? **Read the chapter and formulate your response.**

. . .AND PRACTICAL CONCLUSIONS TO THOSE TAX SCENARIOS

Refocus on the Big Picture. Returning to the client situations introduced in the chapter-opening **Big Picture**, these end-of-chapter summaries and tax planning scenarios apply concepts and topics from the chapter in a reasonable and professional

solution. A **What If?** section then demonstrates how tax treatments might change as a result of potential changes in the filer's situation—making **What If?** a valuable consideration in tax planning.

What If? adds realistic options that will spur you to think about how changes in taxpayers' situations affect their tax consequences and the related tax planning opportunities.



REFOCUS ON THE BIG PICTURE

GOING INTERNATIONAL

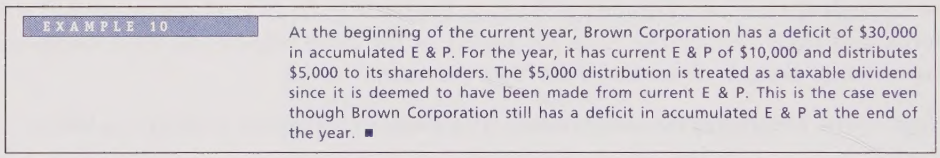
Simply selling into a foreign jurisdiction probably will not trigger any overseas income tax consequences. However, income earned from foreign sales is taxed currently to VoiceCo in the United States. When VoiceCo establishes a CFC in Ireland, it benefits from deferral. As long as the income is not distributed to VoiceCo and as long as the income is not "tainted" Subpart F income, VoiceCo can avoid taxes on the profits of VoiceCo-Ireland. If VoiceCo receives dividends from its foreign subsidiary, it can claim foreign tax credits, which help alleviate the double taxation that would otherwise result.

What If?

VoiceCo is considering building a new manufacturing facility in another state in the United States. How will VoiceCo's expansion decision be affected by state tax considerations? In making the decision to expand, VoiceCo should consider a variety of state tax issues including whether the state imposes a corporate income tax at all and, if so, whether the state requires unitary reporting. Other relevant issues affecting the tax calculation in the state include the apportionment formula used by the state and whether the state has a throwback rule.

EXAMPLES AND LEARNING OBJECTIVES TO HELP YOU STUDY AND EXCEL AT HOMEWORK

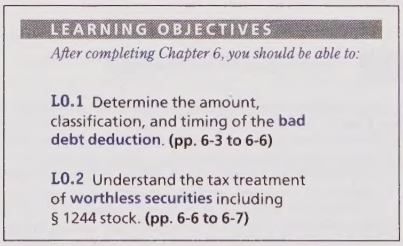
Updated! Examples You Will Use in Every Chapter. An **average of 40 examples in each chapter** use realistic situations to illustrate the complexities of the tax law and demonstrate concepts.



EXAMPLE 10

At the beginning of the current year, Brown Corporation has a deficit of $30,000 in accumulated E & P. For the year, it has current E & P of $10,000 and distributes $5,000 to its shareholders. The $5,000 distribution is treated as a taxable dividend since it is deemed to have been made from current E & P. This is the case even though Brown Corporation still has a deficit in accumulated E & P at the end of the year. ■

Enhanced Learning Objectives with Key Concepts and Page References. Turn to the opening page of any chapter, and you'll find that the key concepts within each Learning Objective are highlighted for you. We've also added page references to each objective to point you to the right section for your study.



LEARNING OBJECTIVES

After completing Chapter 6, you should be able to:

LO.1 Determine the amount, classification, and timing of the **bad debt deduction.** **(pp. 6-3 to 6-6)**

LO.2 Understand the tax treatment of **worthless securities** including § 1244 stock. **(pp. 6-6 to 6-7)**

Homework Linked to Chapter Learning Objectives. Students tell us that for maximum learning value, homework assignments should refer back to specific chapter topics and sections. Each end-of-chapter Question and Problem is labeled with the Learning Objective(s) that appear beside key topics in the text margins. **It is easier to go back to the section of the text where the concept in the homework item is covered—saving you time, better organizing your study, and increasing your confidence in earning a better grade.**

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- **Learning objectives** can be downloaded for each chapter to help keep you on track.

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About the Editors



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Brief Contents

PART 1: THE WORLD OF TAXATION

CHAPTER 1	INTRODUCTION TO TAXATION	1-1
CHAPTER 2	WORKING WITH THE TAX LAW	2-1
CHAPTER 3	TAXES ON THE FINANCIAL STATEMENTS	3-1

PART 2: STRUCTURE OF THE FEDERAL INCOME TAX

CHAPTER 4	GROSS INCOME	4-1
CHAPTER 5	BUSINESS DEDUCTIONS	5-1
CHAPTER 6	LOSSES AND LOSS LIMITATIONS	6-1

PART 3: PROPERTY TRANSACTIONS

CHAPTER 7	PROPERTY TRANSACTIONS: BASIS, GAIN AND LOSS, AND NONTAXABLE EXCHANGES	7-1
CHAPTER 8	PROPERTY TRANSACTIONS: CAPITAL GAINS AND LOSSES, SECTION 1231, AND RECAPTURE PROVISIONS	8-1

PART 4: BUSINESS ENTITIES

CHAPTER 9	CORPORATIONS: ORGANIZATION, CAPITAL STRUCTURE, AND OPERATING RULES	9-1
CHAPTER 10	CORPORATIONS: EARNINGS & PROFITS AND DISTRIBUTIONS	10-1
CHAPTER 11	PARTNERSHIPS AND LIMITED LIABILITY ENTITIES	11-1
CHAPTER 12	S CORPORATIONS	12-1

PART 5: SPECIAL BUSINESS TOPICS

CHAPTER 13 MULTIJURISDICTIONAL TAXATION 13-1

CHAPTER 14 BUSINESS TAX CREDITS AND CORPORATE ALTERNATIVE MINIMUM TAX 14-1

CHAPTER 15 COMPARATIVE FORMS OF DOING BUSINESS 15-1

PART 6: TAXATION OF INDIVIDUALS

CHAPTER 16 INTRODUCTION TO THE TAXATION OF INDIVIDUALS 16-1

CHAPTER 17 INDIVIDUALS AS EMPLOYEES AND PROPRIETORS 17-1

APPENDIXES A-1

INDEX I-1

Contents

PART 1: The World of Taxation

CHAPTER 1 INTRODUCTION TO TAXATION 1–1

The Big Picture: *Mike and Gina Face Reality* 1–2

THE STRUCTURE OF TAXES 1–2
Tax in the News: *Carrying the Tax Burden* 1–3
Tax Rates 1–3
Tax Bases 1–4
Incidence of Taxation 1–4

TYPES OF TAXES 1–4
Tax in the News: *More Excise Taxes from the Federal Government—Good or Bad?* 1–5
Taxes on the Production and Sale of Goods 1–5
Global Tax Issues: *Why Is Gasoline Expensive? It Depends on Where You Live* 1–6
Employment Taxes 1–8
Taxes at Death 1–9
Gift Taxes 1–10
Tax in the News: *The Backdoor Tax Increase* 1–11
Property Taxes 1–11
Tax Fact: *A Profile of Tax Collections* 1–12
Tax Fact: *What Is the U.S. Tax Burden?* 1–13
Taxes on Privileges and Rights 1–13
Income Taxes 1–14
Bridge Discipline: *Bridge to Political Science and Sociology* 1–16
Tax in the News: *Using the Income Tax Return as a "Use Tax" Reminder* 1–17

INCOME TAXATION OF BUSINESS ENTITIES 1–17
Proprietorships 1–17
Corporations 1–18
Partnerships 1–18
S Corporations 1–18
Limited Liability Companies and Limited Liability Partnerships 1–19
Dealings between Individuals and Entities 1–19

TAX PLANNING FUNDAMENTALS 1–19
Overview of Tax Planning 1–19
A General Framework for Income Tax Planning 1–20
Tax Minimization Strategies Related to Income 1–20
Tax Minimization Strategies Related to Deductions 1–22
Tax Minimization Strategies Related to Tax Rates 1–23
Tax Minimization Strategies Related to Credits 1–25
Thinking Outside the Framework 1–26

UNDERSTANDING THE FEDERAL TAX LAW 1–27
Revenue Needs 1–27
Economic Considerations 1–28
Global Tax Issues: *Outsourcing of Tax Return Preparation* 1–29
Social Considerations 1–29
Equity Considerations 1–30
Political Considerations 1–31
Bridge Discipline: *Bridge to Political Science and Sociology* 1–33
Influence of the Internal Revenue Service 1–33
Tax Fact: *The Costs of Complexity* 1–34
Influence of the Courts 1–34

SUMMARY 1–35

Refocus on the Big Picture: *Mike and Gina Face Reality* 1–36

CHAPTER 2 WORKING WITH THE TAX LAW 2–1

The Big Picture: *Researching Tax Questions* 2–2

TAX SOURCES 2–2
Tax Fact: *Scope of the U.S. Tax System* 2–3
Statutory Sources of the Tax Law 2–3
Global Tax Issues: *Tax Treaties* 2–6
Administrative Sources of the Tax Law 2–7
Tax in the News: *Changing the Face of Russia* 2–9
Judicial Sources of the Tax Law 2–11
Bridge Discipline: *Bridge to Public Policy* 2–18

WORKING WITH THE TAX LAW—TAX RESEARCH 2–18
Identifying the Problem 2–19
Bridge Discipline: *Bridge to Business Law* 2–20
Refining the Problem 2–20
Locating the Appropriate Tax Law Sources 2–21
Assessing Tax Law Sources 2–21
Tax in the News: *Internal Revenue Code: Interpretation Pitfalls* 2–22
Tax in the News: *Baseball and Tax Research* 2–24
Arriving at the Solution or at Alternative Solutions 2–25
Communicating Tax Research 2–25

Follow-Up Procedures 2–26
Computers and Tax Research 2–26

TAX RESEARCH ON THE CPA EXAMINATION 2–29
Tax Fact: *An Electronic IRS* 2–30
Bridge Discipline: *Bridge to Regulation and Oversight* 2–31
Refocus on the Big Picture: *Researching Tax Questions* 2–31

CHAPTER 3
TAXES ON THE FINANCIAL STATEMENTS 3–1

The Big Picture: *Taxes on the Financial Statements* 3–2
Tax in the News: *Here, There, and Everywhere—Global Business Structures* 3–3

BOOK-TAX DIFFERENCES 3–3
Different Reporting Entities 3–3
Tax in the News: *A New Code?* 3–4
Tax in the News: *To Deduct or Not to Deduct—The Question Is Answered* 3–5
Different Taxes 3–5
Tax in the News: *Audit Roadmap Expands* 3–6
Different Methods 3–6
Tax in the News: *The Book-Tax Income Gap* 3–9

INCOME TAXES IN THE FINANCIAL STATEMENTS 3–9
GAAP Principles 3–9
Global Tax Issues: *Accounting for Income Taxes in International Standards* 3–11
Valuation Allowance 3–13
Tax in the News: *Even Automaker Is Hurt by the Subprime Mortage Mess* 3–15
Tax Planning Strategies: *Releasing Valuation Allowances* 3–15
Earnings of Foreign Subsidiaries 3–16
Bridge Discipline: *Bridge to Financial Accounting* 3–17
Tax Planning Strategies: *Reducing Effective Tax Rates with ASC 740-30(APB 23) Can Backfire* 3–19
Tax Disclosures in the Financial Statements 3–19
Tax Fact: *Effective Tax Rates for Selected Fortune 100 Companies* 3–22
Tax Planning Strategies: *Tax Savings Are Not Always Created Equal* 3–25

BENCHMARKING 3–26
Bridge Discipline: *Bridge to Financial Analysis* 3–27
Global Tax Issues: *International Accounting Standards on Their Way* 3–28
Refocus on the Big Picture: *Taxes on the Financial Statements* 3–29

PART 2: Structure of the Federal Income Tax

CHAPTER 4
GROSS INCOME 4–1

The Big Picture: *Just What Is Included in Gross Income?* 4–2

THE TAX FORMULA 4–3
Components of the Tax Formula 4–3
Global Tax Issues: *From "All Sources" Is a Broad Definition* 4–4

GROSS INCOME—WHAT IS IT? 4–4
Economic and Accounting Concepts of Income 4–4
Bridge Discipline: *Bridge to Financial Accounting* 4–5
Tax in the News: *The Tax Gap* 4–6
Comparison of the Accounting and Tax Concepts of Income 4–6
Form of Receipt 4–6

YEAR OF INCLUSION 4–7
Taxable Year 4–7
Accounting Methods 4–7
Tax in the News: *Academy Awards Presenters Must "Walk the Line"* 4–8
Bridge Discipline: *Bridge to Economics and Finance* 4–9
Tax Planning Strategies: *Cash Receipts Method* 4–9
Special Rules for Cash Basis Taxpayers 4–10
Tax in the News: *Congress Rescues Lottery Winners from Constructive Receipt Problems* 4–12
Special Rules for Accrual Basis Taxpayers 4–12
Tax Planning Strategies: *Prepaid Income* 4–13

INCOME SOURCES 4–13
Personal Services 4–13
Tax in the News: *The General Welfare Exception* 4–14
Income from Property 4–14
Tax Fact: *How Much and What Type of Income?* 4–15
Global Tax Issues: *Which Foreign Dividends Get the Discounted Rate?* 4–16
Tax Fact: *Business Income and Loss* 4–17
Income Received by an Agent 4–17
Tax Planning Strategies: *Techniques for Reducing Gross Income* 4–18

SPECIFIC ITEMS OF GROSS INCOME 4–18
Tax in the News: *Loans to Executives Prohibited* 4–19
Imputed Interest on Below-Market Loans 4–19
Tax in the News: *U.S. Supreme Court Rules on State Taxation of Other States' Interest* 4–22
Tax Benefit Rule 4–22
Interest on Certain State and Local Government Obligations 4–22
Tax Planning Strategies: *State and Municipal Bonds* 4–23
Improvements on Leased Property 4–24
Life Insurance Proceeds 4–24
Tax in the News: *Corporate-Owned Life Insurance May Not Yield Corporate Benefits* 4–25
Tax Planning Strategies: *Life Insurance* 4–26
Income from Discharge of Indebtedness 4–26
Tax in the News: *Is It an Appropriate Time to Tax?* 4–28
Tax in the News: *One Way to Avoid Bankruptcy* 4–29
Gains and Losses from Property Transactions 4–29
Refocus on the Big Picture: *Just What Is Included in Gross Income?* 4–31

CHAPTER 5
BUSINESS DEDUCTIONS 5–1

The Big Picture: *Calculation of Deductible Expenses* 5–2

OVERVIEW OF BUSINESS DEDUCTIONS 5–3

Ordinary and Necessary Requirement 5–3
Reasonableness Requirement 5–3
Tax Planning Strategies: *Unreasonable Compensation* 5–4

TIMING OF EXPENSE RECOGNITION 5–5
Cash Method Requirements 5–5
Tax Planning Strategies: *Time Value of Tax Deductions* 5–5
Accrual Method Requirements 5–6
Tax in the News: *More Prosecutions under the FCPA* 5–7

DISALLOWANCE POSSIBILITIES 5–7
Public Policy Limitations 5–7
Political Contributions and Lobbying Activities 5–8
Excessive Executive Compensation 5–9
Disallowance of Deductions for Capital Expenditures 5–9
Tax in the News: *Recent Inroads on the Deductibility of Executive Compensation* 5–10
Investigation of a Business 5–10
Transactions between Related Parties 5–11
Lack of Adequate Substantiation 5–13
Expenses and Interest Related to Tax-Exempt Income 5–13

CHARITABLE CONTRIBUTIONS 5–14
Property Contributions 5–15
Tax Fact: *What Ten Percent Ceiling?* 5–16
Limitations Imposed on Charitable Contribution Deductions 5–16

RESEARCH AND EXPERIMENTAL EXPENDITURES 5–17
Expense Method 5–17
Deferral and Amortization Method 5–18

OTHER EXPENSE RULES 5–18
Interest Expense 5–18
Taxes 5–19
Domestic Production Activities Deduction 5–20
Tax Fact: *Cost Recovery by Any Other Name* 5–22

COST RECOVERY ALLOWANCES 5–22
Overview 5–22
Bridge Discipline: *Bridge to Finance* 5–23
Concepts Relating to Depreciation 5–23
Modified Accelerated Cost Recovery System (MACRS) 5–24
Cost Recovery for Personal Property 5–24
Global Tax Issues: *Expensing Asset Costs for Home Office* 5–26
Tax in the News: *Tax Incentives at the Local Level* 5–27
Cost Recovery for Real Estate 5–28
Straight-Line Election 5–29
Farm Property 5–29
Leasehold Improvement Property 5–30
Election to Expense Assets under § 179 5–31
Bridge Discipline: *Bridge to Economics and the Business Cycle* 5–32
Business and Personal Use of Automobiles and Other Listed Property 5–32
Bridge Discipline: *Bridge to Finance and Economics* 5–36
Alternative Depreciation System (ADS) 5–36

AMORTIZATION 5–36
Tax Planning Strategies: *Structuring the Sale of a Business* 5–37

DEPLETION 5–37
Intangible Drilling and Development Costs (IDC) 5–38
Depletion Methods 5–38
Tax Planning Strategies: *Switching Depletion Methods* 5–40

COST RECOVERY TABLES 5–40
Refocus on the Big Picture: *Calculation of Deductible Expenses* 5–44

CHAPTER 6
LOSSES AND LOSS LIMITATIONS 6–1

The Big Picture: *Receiving Tax Benefits from Losses* 6–2

BAD DEBTS 6–3
Tax Fact: *Just How Good Is Your Credit?* 6–3
Specific Charge-Off Method 6–3
Global Tax Issues: *Applying the Tax Benefit Rule* 6–4
Business versus Nonbusiness Bad Debts 6–4
Loans between Related Parties 6–5

WORTHLESS SECURITIES 6–6
Small Business Stock 6–6
Tax Planning Strategies: *Maximizing the Benefits of § 1244* 6–7

CASUALTY AND THEFT LOSSES 6–7
Definition of Casualty 6–7
Definition of Theft 6–8
When to Deduct Casualty Losses 6–8
Tax Planning Strategies: *Documentation of Related-Taxpayer Loans, Casualty Losses, and Theft Losses* 6–9
Measuring the Amount of Loss 6–9
Casualty and Theft Losses of Individuals 6–11
Tax Fact: *The Utility of the NOL Deduction* 6–12

NET OPERATING LOSSES 6–12
Introduction 6–12
Tax in the News: *A Proposal for Changing the Casualty Loss Limits* 6–13
Carryback and Carryover Periods 6–13
Tax in the News: *Tax Savings from NOLs* 6–14

THE TAX SHELTER PROBLEM 6–14
Tax in the News: *Limited Relief under the Stimulus Bill and Subsequent Legislation for Carrybacks* 6–15
Bridge Discipline: *Bridge to Finance* 6–16

AT-RISK LIMITATIONS 6–16

PASSIVE LOSS LIMITS 6–18
Classification and Impact of Passive Income and Loss 6–18
Taxpayers Subject to the Passive Loss Rules 6–21
Tax in the News: *Tax Shelters Have Been Knocked Down, but Not Out!* 6–22
Activity Defined 6–23
Material Participation 6–24
Tax in the News: *Are Nebraska Farmers Similar to Owners of Other LLCs and LLPs?* 6–28
Rental Activities 6–28
Interaction of At-Risk and Passive Activity Limits 6–29
Tax Fact: *Noncompliance Costs with Rental Real Estate* 6–30

Special Rules for Real Estate 6–30
Tax in the News: *Record Keeping Involves Creative Writing for Some!* 6–31
Disposition of Passive Activities 6–33
Tax Planning Strategies: *Utilizing Passive Losses* 6–34
Refocus on the Big Picture: *Receiving Tax Benefits from Losses* 6–35

PART 3: Property Transactions

CHAPTER 7 PROPERTY TRANSACTIONS: BASIS, GAIN AND LOSS, AND NONTAXABLE EXCHANGES 7–1

The Big Picture: *Calculating Basis and Recognized Gain for Property Transactions* 7–2

DETERMINATION OF GAIN OR LOSS 7–3
Realized Gain or Loss 7–3
Bridge Discipline: *Bridge to Financial Accounting* 7–5
Recognized Gain or Loss 7–6
Nonrecognition of Gain or Loss 7–7
Recovery of Capital Doctrine 7–7
Tax in the News: *Triple the Misery!* 7–8

BASIS CONSIDERATIONS 7–8
Determination of Cost Basis 7–8
Tax in the News: *Brokers to Provide Cost Basis Data* 7–9
Gift Basis 7–11
Tax Planning Strategies: *Gift Planning* 7–12
Property Acquired from a Decedent 7–14
Tax Planning Strategies: *Property from a Decedent* 7–15
Disallowed Losses 7–16
Tax Planning Strategies: *Avoiding Wash Sales* 7–17
Conversion of Property from Personal Use to Business or Income-Producing Use 7–17
Summary of Basis Adjustments 7–18

GENERAL CONCEPT OF A NONTAXABLE EXCHANGE 7–18

LIKE-KIND EXCHANGES—§ 1031 7–20
Tax Fact: *Classic Tax Planning Strategy Ignored* 7–21
Tax Planning Strategies: *Like-Kind Exchanges* 7–21
Like-Kind Property 7–21
Tax Fact: *Popularity of Like-Kind Exchanges Grow* 7–22
Tax in the News: *More IRS Oversight of § 1031 Exchanges* 7–23
Exchange Requirement 7–23
Boot 7–24
Basis and Holding Period of Property Received 7–25
Bridge Discipline: *Bridge to Economics* 7–27

INVOLUNTARY CONVERSIONS—§ 1033 7–27
Tax Planning Strategies: *Recognizing Involuntary Conversion Gains* 7–28
Involuntary Conversion Defined 7–28
Tax in the News: *Restricting Eminent Domain: Who Is Harmed?* 7–29
Replacement Property 7–29
Time Limitation on Replacement 7–30

OTHER NONRECOGNITION PROVISIONS 7–31
Transfer of Assets to Business Entity—§§ 351 and 721 7–31
Exchange of Stock for Property—§ 1032 7–31
Certain Exchanges of Insurance Policies—§ 1035 7–31
Exchange of Stock for Stock of the Same Corporation—§ 1036 7–31
Rollovers into Specialized Small Business Investment Companies—§ 1044 7–32
Sale of a Principal Residence—§ 121 7–32
Transfers of Property between Spouses or Incident to Divorce—§ 1041 7–33
Refocus on the Big Picture: *Calculating Basis and Recognized Gain for Property Transactions* 7–33

CHAPTER 8 PROPERTY TRANSACTIONS: CAPITAL GAINS AND LOSSES, SECTION 1231, AND RECAPTURE PROVISIONS 8–1

The Big Picture: *Capital Gains and Losses, § 1231 Gains and Losses, and Recapture* 8–2

GENERAL CONSIDERATIONS 8–3
Rationale for Separate Reporting of Capital Gains and Losses 8–3
General Scheme of Taxation 8–3

CAPITAL ASSETS 8–3
Definition of a Capital Asset 8–3
Tax in the News: *A Private Entity Becomes a Public Corporation* 8–4
Statutory Expansions 8–6
Tax in the News: *Losses on Subprime Mortgages* 8–7

SALE OR EXCHANGE 8–7
Tax in the News: *Bankruptcy and Worthless Stock* 8–8
Worthless Securities and § 1244 Stock 8–8
Retirement of Corporate Obligations 8–8
Options 8–8
Patents 8–10
Franchises, Trademarks, and Trade Names 8–11
Lease Cancellation Payments 8–12

HOLDING PERIOD 8–13
Special Holding Period Rules 8–13
Global Tax Issues: *Trading ADRs on U.S. Stock Exchanges* 8–14
Short Sales 8–15
Tax Planning Strategies: *Timing Capital Gains* 8–16

TAX TREATMENT OF CAPITAL GAINS AND LOSSES OF NONCORPORATE TAXPAYERS 8–16
Capital Gains 8–16
Tax Fact: *Individual Returns Reporting Capital Gains* 8–17
Tax Planning Strategies: *Gifts of Appreciated Securities* 8–17
Global Tax Issues: *Capital Gain Treatment in the United States and Other Countries* 8–18
Capital Losses 8–19
Tax Fact: *Detrimental Tax Treatment for Capital Losses* 8–21

Tax Planning Strategies: *Matching Gains with Losses* 8–22
Small Business Stock 8–22
Tax Fact: *Capital Gains for the Wealthy?* 8–24

TAX TREATMENT OF CAPITAL GAINS AND LOSSES OF CORPORATE TAXPAYERS 8–24

SECTION 1231 ASSETS 8–25
Relationship to Capital Assets 8–25
Property Included 8–25
Tax in the News: *Loss from Cattle Rustling* 8–26
Property Excluded 8–26
Casualty or Theft and Nonpersonal-Use Capital Assets 8–26
General Procedure for § 1231 Computation 8–27

SECTION 1245 RECAPTURE 8–29
Bridge Discipline: *Bridge to Financial Accounting* 8–31
Section 1245 Property 8–31
Tax in the News: *Capital Gains Rates, Business Depreciable Equipment, and Depreciable Real Estate* 8–32
Observations on § 1245 8–32
Tax Planning Strategies: *Depreciation Recapture and § 179* 8–32

SECTION 1250 RECAPTURE 8–33
Unrecaptured § 1250 Gain (Real Estate 25% Gain) 8–33
Additional Recapture for Corporations 8–35

EXCEPTIONS TO §§ 1245 AND 1250 8–35
Gifts 8–35
Tax Planning Strategies: *Selling Depreciable Real Estate* 8–36
Death 8–36
Charitable Transfers 8–36
Global Tax Issues: *Exchange for Foreign Property Yields Recognized Recapture Gain* 8–37
Certain Nontaxable Transactions 8–37
Like-Kind Exchanges and Involuntary Conversions 8–37

REPORTING PROCEDURES 8–38
Tax Planning Strategies: *Timing of Recapture* 8–38

SUMMARY 8–38
Refocus on the Big Picture: *Capital Gains and Losses, § 1231 Gains and Losses, and Recapture* 8–39

PART 4: Business Entities

CHAPTER 9
CORPORATIONS: ORGANIZATION, CAPITAL STRUCTURE, AND OPERATING RULES 9–1

The Big Picture: *Growing into the Corporate Form* 9–2
Global Tax Issues: *Choice of Organizational Form When Operating Overseas* 9–3

AN INTRODUCTION TO CORPORATE TAX 9–3
Double Taxation of Corporate Income 9–3
Tax Fact: *Corporations' Reporting Responsibilities* 9–4
Comparison of Corporations and Other Forms of Doing Business 9–5
Bridge Discipline: *Bridge to Finance* 9–6
Nontax Considerations 9–7
Limited Liability Companies 9–7
Entity Classification 9–8
Tax Planning Strategies: *Related Groups May Utilize Check-the-Box Regulations* 9–8

ORGANIZATION OF AND TRANSFERS TO CONTROLLED CORPORATIONS 9–8
In General 9–8
Transfer of Property 9–10
Stock 9–11
Control of the Corporation 9–11
Tax Planning Strategies: *Utilizing § 351* 9–12
Global Tax Issues: *Does § 351 Cover the Incorporation of a Foreign Business?* 9–15
Assumption of Liabilities—§ 357 9–15
Tax Planning Strategies: *Avoiding § 351* 9–18
Basis Determination and Other Issues 9–18
Recapture Considerations 9–23
Tax Planning Strategies: *Other Considerations When Incorporating a Business* 9–23
Tax in the News: *Government-Provided Economic Incentives Can Flow on a Two-Way Street* 9–24

CAPITAL STRUCTURE OF A CORPORATION 9–24
Capital Contributions 9–24
Tax in the News: *Debt That Cannot Be Fully Repaid* 9–25
Debt in the Capital Structure 9–25

CORPORATE OPERATIONS 9–28
Deductions Available Only to Corporations 9–28
Tax Planning Strategies: *Organizational Expenditures* 9–31
Determining the Corporate Income Tax Liability 9–31
Tax Liability of Related Corporations 9–32
Controlled Groups 9–33

PROCEDURAL MATTERS 9–34
Filing Requirements for Corporations 9–34
Estimated Tax Payments 9–34
Schedule M–1—Reconciliation of Taxable Income and Financial Net Income 9–35
Tax Fact: *Sources of Federal Government Revenues* 9–36
Bridge Discipline: *Bridge to Financial Accounting* 9–37
Schedule M–3—Net Income (Loss) Reconciliation for Corporations with Total Assets of $10 Million or More 9–37
Tax in the News: *Impact of IFRS on Schedule M–3* 9–38
Effect of Taxes on Financial Statements 9–38

SUMMARY 9–38
Refocus on the Big Picture: *Growing into the Corporate Form* 9–39

CHAPTER 10
CORPORATIONS: EARNINGS & PROFITS AND DISTRIBUTIONS 10–1

The Big Picture: *Taxing Corporate Distributions* 10–2

CORPORATE DISTRIBUTIONS—OVERVIEW 10–2
Tax Fact: *Who Pays Dividends?* 10–3

EARNINGS AND PROFITS (E & P) 10–3
Computation of E & P 10–4
Summary of E & P Adjustments 10–7
Allocating E & P to Distributions 10–7
Tax in the News: *The Bailout Paid Big Dividends* 10–8
Bridge Discipline: *Bridge to Finance* 10–9
Tax Planning Strategies: *Corporate Distributions* 10–11
Bridge Discipline: *Bridge to Investments* 10–12

PROPERTY DIVIDENDS 10–12
Property Dividends—Effect on the Shareholder 10–12
Tax in the News: *Credit Crunch Triggers Record Dividend Cuts* 10–13
Property Dividends—Effect on the Corporation 10–13
Bridge Discipline: *Bridge to Finance* 10–14

CONSTRUCTIVE DIVIDENDS 10–15
Types of Constructive Dividends 10–15
Global Tax Issues: *A Worldwide View of Dividends* 10–17
Tax in the News: *Hard Work Pays Off!* 10–18
Tax Treatment of Constructive Dividends 10–18
Tax Fact: *Dividend Payments React to Tax Law Changes* 10–19
Tax Planning Strategies: *Constructive Dividends* 10–19

STOCK DIVIDENDS 10–20

STOCK REDEMPTIONS 10–21
Bridge Discipline: *Bridge to Finance* 10–22
Tax in the News: *Capital Restructuring by Charles Schwab Results in Redemption of 102 Million Shares* 10–23
Tax Planning Strategies: *Stock Redemptions* 10–24

CORPORATE LIQUIDATIONS 10–24
The Liquidation Process 10–24
Global Tax Issues: *Foreign Shareholders Prefer Sale or Exchange Treatment in Stock Redemptions* 10–24
Liquidating and Nonliquidating Distributions Compared 10–25
Tax Planning Strategies: *Corporate Liquidations* 10–25

RESTRICTIONS ON CORPORATE ACCUMULATIONS 10–26
Refocus on the Big Picture: *Taxing Corporate Distributions* 10–27

CHAPTER 11
PARTNERSHIPS AND LIMITED LIABILITY ENTITIES 11–1

The Big Picture: *The Tax Consequences of Partnership Formation and Operations* 11–2

OVERVIEW OF PARTNERSHIP TAXATION 11–2
Tax Fact: *Partnership Power* 11–3
Forms of Doing Business—Federal Tax Consequences 11–3
Bridge Discipline: *Bridge to Finance* 11–4
What Is a Partnership? 11–4
Tax in the News: *A Partnership with Limits* 11–5
Partnership Taxation and Reporting 11–5
Tax Fact: *Look at All the LLCs* 11–6
Bridge Discipline: *Bridge to Financial Accounting* 11–8
Partner's Ownership Interest in a Partnership 11–8

FORMATION OF A PARTNERSHIP: TAX EFFECTS 11–9
Gain or Loss on Contributions to the Partnership 11–9
Exceptions to Nonrecognition 11–10
Tax Issues Related to Contributed Property 11–11
Inside and Outside Bases 11–13
Tax Accounting Elections 11–14
Initial Costs of a Partnership 11–14

OPERATIONS OF THE PARTNERSHIP 11–16
Reporting Operating Results 11–16
Global Tax Issues: *Various Withholding Procedures Apply to Foreign Partners* 11–17
Partnership Allocations 11–19
Bridge Discipline: *Bridge to Business Law* 11–20
Tax Fact: *What Do Partnerships Do?* 11–21
Basis of a Partnership Interest 11–21
Partner's Basis, Gain, and Loss 11–23
Loss Limitations 11–26
Tax Planning Strategies: *Make Your Own Tax Shelter* 11–27
Tax Fact: *Whose Money Are We Losing?* 11–28
Tax Planning Strategies: *Formation and Operation of a Partnership* 11–29

TRANSACTIONS BETWEEN PARTNER AND PARTNERSHIP 11–30
Guaranteed Payments 11–30
Other Transactions between a Partner and a Partnership 11–31
Partners as Employees 11–32
Tax Planning Strategies: *Transactions between Partners and Partnerships* 11–33

LIMITED LIABILITY ENTITIES 11–33
Limited Liability Companies 11–33
Global Tax Issues: *Partnerships Around the World* 11–35
Limited Liability Partnerships 11–35

SUMMARY 11–36
Refocus on the Big Picture: *The Tax Consequences of Partnership Formation and Operations* 11–36

CHAPTER 12
S CORPORATIONS 12–1

The Big Picture: *Converting a C Corporation to an S Corporation* 12–2
Tax Fact: *The Business of S Corporations* 12–3

AN OVERVIEW OF S CORPORATIONS 12–3
Bridge Discipline: *Bridge to Business Law* 12–4

QUALIFYING FOR S CORPORATION STATUS 12–4
Definition of a Small Business Corporation 12–4
Tax Planning Strategies: *When to Elect S Corporation Status* 12–5
Tax in the News: *S Corporation Audits* 12–6
Tax Planning Strategies: *Beating the 100-Shareholder Limit* 12–7
Making the Election 12–7
Shareholder Consent 12–8
Tax Planning Strategies: *Making a Proper Election* 12–8

Loss of the Election 12–8
Tax Planning Strategies: *Preserving the S Election* 12–10

OPERATIONAL RULES 12–11
Computation of Taxable Income 12–11
Allocation of Income and Loss 12–12
Tax Fact: *A "Small" Business Corporation* 12–13
Tax in the News: *An Abusive Tax Shelter?* 12–14
Tax Planning Strategies: *Salary Structure* 12–14
Tax Treatment of Distributions to Shareholders 12–15
Tax Planning Strategies: *The Accumulated Adjustments Account* 12–18
Tax Treatment of Noncash Distributions by the Corporation 12–19
Shareholder's Basis 12–20
Tax Planning Strategies: *Working with Suspended Losses* 12–22
Treatment of Losses 12–22
Tax Planning Strategies: *Loss Considerations* 12–23
Other Operational Rules 12–24

ENTITY-LEVEL TAXES 12–25
Tax on Pre-Election Built-In Gain 12–25
Tax Planning Strategies: *Managing the Built-In Gains Tax* 12–27
Tax Fact: *No Double Taxation?* 12–28
Passive Investment Income Penalty Tax 12–28
Tax Planning Strategies: *Avoid PII Pitfalls* 12–29

SUMMARY 12–29
Tax Fact: *The S Corporation Economy* 12–30
Refocus on the Big Picture: *Converting a C Corporation to an S Corporation* 12–30

PART 5: Special Business Topics

CHAPTER 13
MULTIJURISDICTIONAL TAXATION 13–1

The Big Picture: *Going International* 13–2

THE MULTIJURISDICTIONAL TAXPAYER 13–2
Bridge Discipline: *Bridge to International Law* 13–3

U.S. TAXATION OF MULTINATIONAL TRANSACTIONS 13–3
Sources of Law 13–4
Tax Fact: *U.S. Income Tax Treaties in Force* 13–5
Tax Planning Strategies: *Treaty Shopping* 13–6
Tax Issues 13–6
Tax Fact: *Where Do We Stand?* 13–7
Tax in the News: *Last Chance to Come Clean on Foreign Bank Accounts* 13–8
Tax Planning Strategies: *Deferral and Repatriation* 13–9
Tax in the News: *Sourcing Income in Cyberspace* 13–9
Tax Planning Strategies: *Sourcing Income from Sales of Inventory* 13–10
Tax Fact: *Corporate Use of the Foreign Tax Credit* 13–12
Tax Planning Strategies: *Utilizing the Foreign Tax Credit* 13–13
Tax in the News: *Bring It on Home* 13–16
Tax Fact: *Who Are These CFCs?* 13–17
Tax Planning Strategies: *Avoiding Constructive Dividends* 13–18
Tax in the News: *A Deferral for an End to Deferral?* 13–19
Tax Fact: *The Inbound Sector* 13–19

CROSSING STATE LINES: STATE AND LOCAL INCOME TAXATION IN THE UNITED STATES 13–21
Sources of Law 13–21
Tax Fact: *State Tax Revenue Sources* 13–22
Tax in the News: *So Where Did You Work Today?* 13–23
Tax Issues 13–23
Tax Planning Strategies: *Nexus: To Have or Have Not* 13–24
Tax in the News: *State Deficits Change How Revenue Departments Work* 13–27
Tax Planning Strategies: *Where Should My Income Go?* 13-28

COMMON CHALLENGES 13–29
Authority to Tax 13–29
Division of Income 13–29
Tax in the News: *Finding New Revenues* 13–30
Transfer Pricing 13–30
Tax in the News: *States in a Bind on Sales/Use Tax on Internet Sales* 13–31
Bridge Discipline: *Bridge to Cost Accounting and Executive Compensation* 13–32
Tax in the News: *A Move to the Beach for U.S. Corporations Seeking a Vacation from U.S. Tax Rules* 13–33
Tax Fact: *The OECD's Tax Haven Blacklist* 13–33
Tax Havens 13–34
Tax Planning Strategies: *Holding Companies Make Other States Angry* 13–34
Interjurisdictional Agreements 13–34
Refocus on the Big Picture: *Going International* 13–35

CHAPTER 14
BUSINESS TAX CREDITS AND CORPORATE ALTERNATIVE MINIMUM TAX 14–1

The Big Picture: *Dealing with Tax Credits and the AMT* 14–2

TAX POLICY AND TAX CREDITS 14–2
Tax Fact: *Where Have All the Credits Gone?* 14–3

SPECIFIC BUSINESS-RELATED TAX CREDIT PROVISIONS 14–3
General Business Credit 14–3
Tax in the News: *Many Taxpayers Become "Nonpayers" because of Tax Credits* 14–3
Bridge Discipline: *Bridge to Finance* 14–5
Tax Credit for Rehabilitation Expenditures 14–5
Work Opportunity Tax Credit 14–7
Research Activities Credit 14–8
Energy Credits 14–10
Jobs Credit 14–10
Disabled Access Credit 14–10
Credit for Small Employer Pension Plan Startup Costs 14–11
Credit for Employer-Provided Child Care 14–11
Global Tax Issues: *Sourcing Income in Cyberspace—Getting It Right When Calculating the Foreign Tax Credit* 14–12
Foreign Tax Credit 14–12

CORPORATE ALTERNATIVE MINIMUM TAX 14–13
The AMT Formula 14–15
Tax Preferences 14–16
Tax Fact: *The Reach of the AMT* 14–17
Tax in the News: *The AMT: From 155 to 35.5 Million* 14–18
AMT Adjustments 14–18
Tax in the News: *Distinguishing between Taxable and Exempt Bonds for AMT Purposes* 14–19
Tax Planning Strategies: *Avoiding Preferences and Adjustments* 14–24
Adjusted Current Earnings (ACE) 14–25
Computing Alternative Minimum Taxable Income 14–27
Tax Planning Strategies: *Optimum Use of the AMT and Regular Corporate Income Tax Rate Difference* 14–28
AMT Rate and Exemption 14–28
Tax Planning Strategies: *Controlling the Timing of Preferences and Adjustments* 14–28
Minimum Tax Credit 14–28
Other Aspects of the AMT 14–29
Tax Planning Strategies: *The S Corporation Option* 14–29

INDIVIDUAL ALTERNATIVE MINIMUM TAX 14–29
Tax in the News: *Is a New Version of the AMT Needed?* 14–30
Refocus on the Big Picture: *Dealing with Tax Credits and the AMT* 14–30

CHAPTER 15
COMPARATIVE FORMS OF DOING BUSINESS 15–1

The Big Picture: *What Business Form Should I Choose?* 15–2
Tax in the News: *Should You Check That Box?* 15–3

FORMS OF DOING BUSINESS 15–3
Principal Forms 15–3
Tax in the News: *Professional Service Firms and Organizational Form* 15–4
Limited Liability Companies 15–4
Tax Fact: *Revenue Relevance of Corporate versus Individual Taxpayers* 15–5

NONTAX FACTORS 15–5
Capital Formation 15–5
Limited Liability 15–6
Other Factors 15–7

SINGLE VERSUS DOUBLE TAXATION 15–7
Overall Impact on Entity and Owners 15–7
Bridge Discipline: *Bridge to Business Law and Financial Accounting* 15–8
Tax Planning Strategies: *Selling Stock versus Selling Corporate Assets* 15–9
Alternative Minimum Tax 15–9
Tax in the News: *Do Corporations Pay Taxes?* 15–9
Tax Planning Strategies: *Planning for the AMT* 15–10
State Taxation 15–10
Tax in the News: *Who Pays Corporate AMT?* 15–11

MINIMIZING DOUBLE TAXATION 15–11
Making Deductible Distributions 15–11
Tax in the News: *Who Pays the Corporate Federal Income Tax and Why It Is Decreasing* 15–12
Not Making Distributions 15–12
Return of Capital Distributions 15–13
Bridge Discipline: *Bridge to Economics* 15–14
Electing S Corporation Status 15–14
Tax Fact: *Number of Income Tax Returns Filed by Different Types of Taxpayers (in Millions)* 15–15

CONDUIT VERSUS ENTITY TREATMENT 15–15
Effect on Recognition at Time of Contribution to the Entity 15–15
Effect on Basis of Ownership Interest 15–16
Tax in the News: *A Tax Reversal: State Governments Pay for Jobs* 15–17
Effect on Results of Operations 15–17
Effect on Recognition at Time of Distribution 15–18
Tax in the News: *Certain Partnership Distributions of Appreciated Property* 15–19
Effect on Passive Activity Losses 15–19
Effect of At-Risk Rules 15–19
Tax in the News: *When Rent Is Active Rather Than Passive* 15–20
Effect of Special Allocations 15–20
Tax Fact: *Partnership Income Tax Returns: Profits versus Losses* 15–21

DISPOSITION OF A BUSINESS OR AN OWNERSHIP INTEREST 15–21
Sole Proprietorships 15–22
Tax in the News: *A One-Way Street for Partners* 15–23
Partnerships and Limited Liability Entities 15–23
Tax Planning Strategies: *Selling Stock or Assets* 15–24
C Corporations 15–24
S Corporations 15–24

OVERALL COMPARISON OF FORMS OF DOING BUSINESS 15–25
Tax Planning Strategies: *Choosing a Business Form: Case Study* 15–31
Refocus on the Big Picture: *What Business Form Should I Choose?* 15–31

PART 6: Taxation of Individuals

CHAPTER 16
INTRODUCTION TO THE TAXATION OF INDIVIDUALS 16–1

The Big Picture: *The Tax Implications of Life!* 16–2

THE INDIVIDUAL TAX FORMULA 16–3
Components of the Tax Formula 16–3
Tax Fact: *The Government's Interest in Our Work* 16–4
Global Tax Issues: *Citizenship Is Not Tax-Free* 16–6

STANDARD DEDUCTION 16–8
Basic and Additional Standard Deduction 16–8
Real Property Taxes and Auto Sales Taxes Standard Deductions 16–9

Special Limitations on the Standard Deduction for Dependents 16–10

PERSONAL EXEMPTIONS 16–10

DEPENDENCY EXEMPTIONS 16–12
Qualifying Child 16–12
Qualifying Relative 16–13
Tax Planning Strategies: *Multiple Support Agreements and the Medical Expense Deduction* 16–16
Other Rules for Dependency Exemptions 16–17
Tax Planning Strategies: *Problems with a Joint Return* 16–17
Comparison of Categories for Dependency Exemptions 16–17
Phaseout of Exemptions 16–18

TAX DETERMINATION—FILING CONSIDERATIONS 16–18
Tax in the News: *How to Subtly Pluck the Chicken* 16–19
Filing Requirements 16–19
Tax Fact: *What Form of Tax Compliance Is Right for You?* 16–21
Filing Status 16–21
Bridge Discipline: *Bridge to Equity or Fairness* 16–22
Global Tax Issues: *Filing a Joint Return* 16–23

TAX DETERMINATION—COMPUTATION PROCEDURES 16–23
Tax Table Method 16–24
Tax Rate Schedule Method 16–24
Tax Planning Strategies: *Shifting Income and Deductions across Time* 16–25
Computation of Net Taxes Payable or Refund Due 16–25
Tax Fact: *The Tightening Tax Squeeze* 16–26
Kiddie Tax—Unearned Income of Children Taxed at Parents' Rate 16–26
Tax Planning Strategies: *Income of Certain Children* 16–28

OVERVIEW OF INCOME PROVISIONS APPLICABLE TO INDIVIDUALS 16–28

SPECIFIC INCLUSIONS APPLICABLE TO INDIVIDUALS 16–28
Bridge Discipline: *Bridge to Economics and Finance* 16–29
Alimony and Separate Maintenance Payments 16–29
Prizes and Awards 16–30
Tax in the News: *The Appropriate Age for Social Security Benefits* 16–31
Unemployment Compensation 16–31
Social Security Benefits 16–31

SPECIFIC EXCLUSIONS APPLICABLE TO INDIVIDUALS 16–31
Gifts and Inheritances 16–31
Scholarships 16–32
Damages 16–33
Workers' Compensation 16–34
Accident and Health Insurance Benefits 16–35
Educational Savings Bonds 16–35

ITEMIZED DEDUCTIONS 16–36
Medical Expenses 16–37
Tax in the News: *The President and Vice President Itemize* 16–39
Taxes 16–41
Global Tax Issues: *Deductibility of Foreign Taxes* 16–43
Tax Planning Strategies: *Timing the Payment of Deductible Taxes* 16–43
Interest 16–43
Charitable Contributions 16–47
Global Tax Issues: *Choose the Charity Wisely* 16–49
Miscellaneous Itemized Deductions Subject to Two Percent Floor 16–52
Other Miscellaneous Deductions 16–52
Overall Limitation on Certain Itemized Deductions 16–53
Tax Planning Strategies: *Effective Utilization of Itemized Deductions* 16–53

INDIVIDUAL TAX CREDITS 16–53
Adoption Expenses Credit 16–53
Child Tax Credit 16–54
Credit for Child and Dependent Care Expenses 16–54
Education Tax Credits 16–56
Earned Income Credit 16–58
Making Work Pay Credit 16–59
Refocus on the Big Picture: *The Tax Implications of Life!* 16–59

CHAPTER 17
INDIVIDUALS AS EMPLOYEES AND PROPRIETORS 17–1

The Big Picture: *Self-Employed versus Employee—What's the Difference?* 17–2
Bridge Discipline: *Bridge to Equity or Fairness and Business Law* 17–3

EMPLOYEE VERSUS SELF-EMPLOYED 17–3
Tax in the News: *Self-Employed or Employed? Misclassification Can Be Costly!* 17–4
Factors Considered in Classification 17–4
Tax Planning Strategies: *Self-Employed Individuals* 17–5

EXCLUSIONS AVAILABLE TO EMPLOYEES 17–5
Advantages of Qualified Fringe Benefits 17–5
Employer-Sponsored Accident and Health Plans 17–6
Medical Reimbursement Plans 17–6
Bridge Discipline: *Bridge to Economic and Societal Needs* 17–7
Long-Term Care Benefits 17–7
Meals and Lodging Furnished for the Convenience of the Employer 17–8
Group Term Life Insurance 17–10
Qualified Tuition Reduction Plans 17–11
Other Specific Employee Fringe Benefits 17–11
Tax in the News: *Employee Tuition Assistance Offers Benefits to Employers Too* 17–12
Cafeteria Plans 17–12
Tax in the News: *Providing a Feel-Good Fringe Benefit at a Low Cost* 17–13
Flexible Spending Plans 17–13
General Classes of Excluded Benefits 17–13
Tax in the News: *Employees Lose Some under "Use or Lose Plans"* 17–14
Taxable Fringe Benefits 17–18
Foreign Earned Income 17–18

EMPLOYEE EXPENSES 17–19

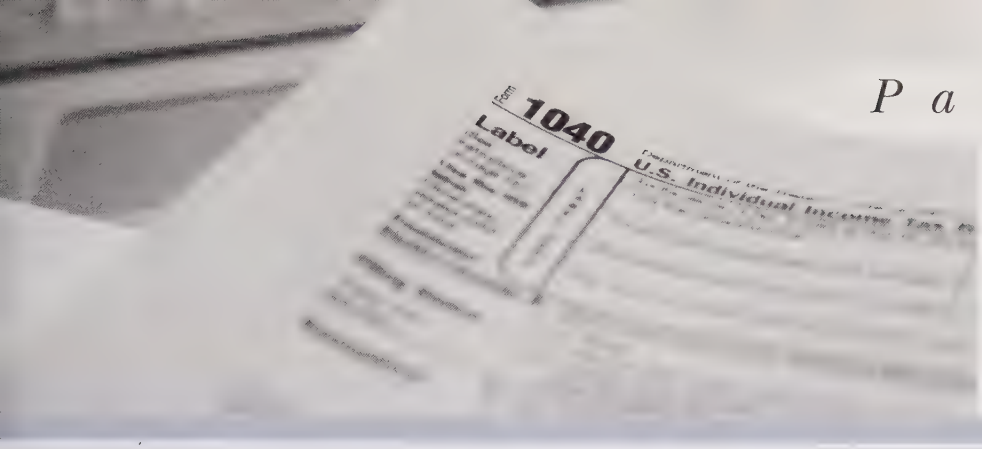
Transportation Expenses 17–20
Tax in the News: *Turning a Saturday Leisure Day into a Business Day* 17–22
Travel Expenses 17–22
Tax in the News: *Relief for Members of the Armed Forces Reserves* 17–23
Tax Planning Strategies: *Transportation and Travel Expenses* 17–25
Moving Expenses 17–25
Global Tax Issues: *Expatriates and the Moving Expense Deduction* 17–26
Tax in the News: *Even the Smithsonian Can't Get It Right* 17–27
Tax Planning Strategies: *Moving Expenses* 17–27
Tax in the News: *Is an MBA Degree Deductible?* 17–28
Education Expenses 17–28
Tax Planning Strategies: *Education Expenses* 17–29
A Limited Deduction Approach 17–30
Entertainment Expenses 17–31
Tax Planning Strategies: *Entertainment Expenses* 17–32
Other Employee Expenses 17–33
Tax in the News: *The Office in the Home Deduction Is Not Being Fully Realized* 17–34
Tax in the News: *One Side Effect of 9/11* 17–36
Classification of Employee Expenses 17–36
Tax Planning Strategies: *Unreimbursed Employee Business Expenses* 17–38
Contributions to Individual Retirement Accounts 17–38
Tax Fact: *The Vacillating Popularity of IRAs* 17–40
Tax in the News: *IRA Losses from a Ponzi Scheme* 17–41

INDIVIDUALS AS PROPRIETORS 17–42
The Proprietorship as a Business Entity 17–42
Income of a Proprietorship 17–43
Deductions Related to a Proprietorship 17–43
Tax in the News: *The Tax Gap Includes $58 Billion in Payroll Taxes* 17–44
Retirement Plans for Self-Employed Individuals 17–45
Tax Fact: *Increasing Popularity of Keogh Plans* 17–46
Tax Planning Strategies: *Important Dates Related to IRAs and Keogh Plans* 17–47
Tax Planning Strategies: *Factors Affecting Retirement Plan Choices* 17–48
Accounting Periods and Methods 17–48
Estimated Tax Payments 17–48

HOBBY LOSSES 17–50
General Rules 17–50
Presumptive Rule of § 183 17–50
Determining the Amount of the Deduction 17–51
Refocus on the Big Picture: *Self-Employed versus Employee—What's the Difference?* 17–52

APPENDIXES

TAX RATE SCHEDULES AND TABLES A-1
TAX FORMS B-1
GLOSSARY C-1
TABLE OF CODE SECTIONS CITED D-1
TABLE OF REGULATIONS CITED D-8
TABLE OF REVENUE PROCEDURES AND REVENUE RULINGS CITED D-11
TABLE OF CASES CITED E-1
PRESENT VALUE AND FUTURE VALUE TABLES F-1
INDEX I-1



Part 1

The World of Taxation

CHAPTER 1 Introduction to Taxation

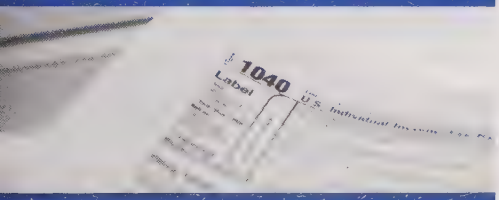
CHAPTER 2 Working with the Tax Law

CHAPTER 3 Taxes on the Financial Statements

Part 1 provides an introduction to taxation in the United States. Various taxes imposed by Federal, state, and local governments are discussed. A unique tax planning framework is developed that is applied throughout the book in developing tax planning strategies for business entities and for individual taxpayers. This tax planning framework serves as a unifying theme throughout the book. The role of the IRS and the courts in the evolution of the Federal tax system is presented. The tax research process, including the relevance of the legislative, administrative, and judicial sources of the tax law, is discussed. Part 1 concludes with a chapter on accounting for income taxes.

CHAPTER 1

Introduction to Taxation



LEARNING OBJECTIVES

After completing Chapter 1, you should be able to:

LO.1 Understand the **components of a tax.** **(pp. 1-2 to 1-4)**

LO.2 Identify the various **taxes affecting business enterprises.** **(pp. 1-4 to 1-14)**

LO.3 Recall the **basic tax formula** for individuals and taxable business entities. **(pp. 1-14 to 1-15)**

LO.4 Understand the **relationship between business entities and their owners.** **(pp. 1-17 to 1-19)**

LO.5 Recognize **tax planning** opportunities and apply a general framework for tax planning. **(pp. 1-19 to 1-27)**

LO.6 Recognize the **economic, social, equity, and political considerations that underlie the tax law.** **(pp. 1-27 to 1-33)**

LO.7 Describe the **role played by the IRS and the courts** in the evolution of the Federal tax system. **(pp. 1-33 to 1-35)**

TAX *Talk*

How many people were taxed, who was taxed, and what was taxed tell more about a society than anything else.

—CHARLES ADAMS

OUTLINE

1.1 The Structure of Taxes, 1-2
Tax Rates, 1-3
Tax Bases, 1-4
Incidence of Taxation, 1-4
1.2 Types of Taxes, 1-4
Taxes on the Production and Sale of Goods, 1-5
Employment Taxes, 1-8
Taxes at Death, 1-9
Gift Taxes, 1-10
Property Taxes, 1-11
Taxes on Privileges and Rights, 1-13
Income Taxes, 1-14
1.3 Income Taxation of Business Entities, 1-17
Proprietorships, 1-17
Corporations, 1-18
Partnerships, 1-18
S Corporations, 1-18
Limited Liability Companies and Limited Liability Partnerships, 1-19
Dealings between Individuals and Entities, 1-19
1.4 Tax Planning Fundamentals, 1-19
Overview of Tax Planning, 1-19
A General Framework for Income Tax Planning, 1-20
Tax Minimization Strategies Related to Income, 1-20
Tax Minimization Strategies Related to Deductions, 1-22
Tax Minimization Strategies Related to Tax Rates, 1-23
Tax Minimization Strategies Related to Credits, 1-25
Thinking Outside the Framework, 1-26
1.5 Understanding the Federal Tax Law, 1-27
Revenue Needs, 1-27
Economic Considerations, 1-28
Social Considerations, 1-29
Equity Considerations, 1-30
Political Considerations, 1-31
Influence of the Internal Revenue Service, 1-33
Influence of the Courts, 1-34
1.6 Summary, 1-35

THE BIG PICTURE Tax Solutions for the Real World

MIKE AND GINA FACE REALITY

Mike and Gina are reviewing their annual budget and are dismayed to learn that they paid taxes equal to over 35 percent of last year's income. Mike is self-employed and earned $100,000 of income that is subject to Federal income tax. Gina works for a large corporation as a marketing executive and also earns $100,000 of taxable wages. Their combined Federal taxable income was $170,000. Although they know that the top Federal tax rate is 35 percent, they were in the 28 percent tax bracket last year. Is it possible that they really paid that much tax, since they were not subject to the top tax rate? **Read the chapter and formulate your response.**

Taxes have a pervasive impact on our lives. They affect every individual in the United States from birth to death, and even beyond death (through taxation of the individual's estate). Taxes likewise affect every business from formation of the business entity to its operations, distribution of profits to owners, and ultimate disposition or liquidation.

Despite the wide-ranging impact of taxes, most studies of the tax law overemphasize the provisions applying to individual taxpayers and ignore much of the tax law relevant to business. That approach fails to address the role of taxes in *business decisions*, and it fails to provide the broad knowledge base necessary to succeed in today's business environment. This text adopts a more balanced approach; it introduces the tax laws that apply to all business entities and surveys the tax rules specific to each type of entity. It also recognizes that both tax and nontax considerations are important in business planning and therefore presents the tax laws within the context of the business transactions to which they relate.

LO.1
Understand the components of a tax.

1.1 The Structure of Taxes

Most taxes have two components: a tax rate and a tax base (such as income, wages, value, or sales price). Tax liability is computed by multiplying these two components. Taxes vary by the structure of their rates and by the base subject to tax.

TAX in the NEWS

CARRYING THE TAX BURDEN

Data from the Congressional Budget Office indicate that the progressive nature of the Federal income tax, accelerated by laws passed under Presidents Bush I and Clinton, remains largely intact, even after the broad tax cuts issued under President Bush II.

Annual median income (defining the upper and lower one-half of citizens) is about $33,000. Income of more than $410,000 puts a taxpayer in the top 1 percent of filers, and effective Federal taxes for the top 10 percent of earners have increased faster than their incomes. The following table shows the share of Federal taxes paid by various income categories.

Income Category	Share of Total Income (%)	Share of Federal Income Taxes Paid (%)
Top 1%	22.9	40.4
Top 5%	37.4	60.7
Bottom 50%	12.3	3.0

Additional observations include the following.

Individuals earning less than $40,000 per year likely pay zero Federal income tax, and their payroll and gasoline taxes may be partly rebated through the earned income credit as well.

Much of the increase in the tax share paid by the upper-level earners can be traced to the cut in rates on dividend and long-term capital gain income.

TAX RATES

Tax rates can be either progressive, proportional, or regressive. A tax rate is *progressive* if it increases as the tax base increases. The Federal income tax and the Federal estate and **gift taxes** are progressive. For example, the Federal income tax rates for corporations range from 15 to 39 percent. These rates increase with increases in taxable income.

EXAMPLE 1

Refer to the corporate Tax Rate Schedule inside the front cover of this text. If Abel Corporation has taxable income of $5,000, its income tax is $750 and its average tax rate is 15% ($750/$5,000, or the ratio of tax liability to the tax base). If, however, Abel's taxable income is $200,000, its income tax is $61,250 [$22,250 + 0.39($200,000 − $100,000)], and its average tax rate is 30.63% ($61,250/$200,000). The tax is progressive because the average tax rate increases with increases in the tax base (income). ■

A tax is *proportional* if the rate of tax is constant, regardless of the size of the tax base. State retail **sales taxes** are proportional, as is the Federal Medicare tax on salaries and wages. Proportional tax rates also underlie the various "flat tax" proposals recently in the news.[1]

EXAMPLE 2

Bob purchases an automobile for $6,000. If the sales tax on automobiles is 7% in Bob's state, he will pay a $420 tax. Alternatively, if Bob pays $20,000 for a car, his sales tax will be $1,400 (still 7% of the sales price). Because the average tax rate does not change with the tax base (sales price), the sales tax is proportional. ■

Finally, *regressive* tax rates decrease as the tax base increases. Federal **employment taxes**, such as FICA and FUTA, are regressive. When the tax base and the taxpayer's ability to pay generally are positively correlated (i.e., when they move in the same direction), many tax pundits view regressive tax rates as unfair. This is because the tax burden decreases as a *percentage* of the taxpayer's ability to pay.

[1]Flat tax proposals call for a new tax with one low, proportional rate (usually between 15% and 20%). Such a tax would have a very broad base, taxing almost all forms of income with few deductions. To avoid taxing the poor, large personal exemptions would be provided (e.g., $50,000 for a family of four).

EXAMPLE 1

In 2010, the combined Social Security and Medicare tax rate levied on the wages of employees is 7.65% up to a maximum of $106,800 and 1.45% on all wages over $106,800. Sarah earns a salary of $30,000. She pays FICA taxes of $2,295, with an average tax rate of 7.65%. Alternatively, if Sarah earns $120,000, she pays $8,362 [(0.0765 × $106,800) + 0.0145 × ($120,000 − $106,800)], with an average tax rate of 6.97%. Once the FICA base exceeds the maximum amount subject to the Social Security part of FICA, the FICA tax becomes regressive, since the average tax rate decreases as the tax base increases. ■

Under all three tax rate structures, the *amount* of taxes due increases as the tax base increases. The structure of tax rates only affects the *rate* of increase (i.e., progressive taxes increase at an increasing rate, proportional taxes increase at a constant rate, and regressive taxes increase at a decreasing rate).

TAX BASES

Most taxes are levied on one of four kinds of tax bases.

- Transactions (including sales or purchases of goods and services and transfers of wealth).
- Property or wealth (including ownership of specific kinds of property).
- Privileges and rights (including the ability to do business as a corporation, the right to work in a certain profession, and the ability to move goods between countries).
- Income, on a gross or net-of-expenses basis.

Because the Federal income tax usually has the most significant influence on business decisions, it is the principal focus of this text. Other taxes can play an important role, however, so it is important to have at least some familiarity with them. The next section introduces many of the taxes imposed on individuals and businesses in the United States.

DIGGING DEEPER 1

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

INCIDENCE OF TAXATION

The degree to which various segments of society share the total tax burden is difficult to assess. Assumptions must be made concerning who absorbs the burden of paying the tax. For example, since dividend payments to shareholders are not deductible by a corporation and are generally taxable to shareholders, the same income is subject to a form of double taxation. Concern over double taxation is valid to the extent that corporations are *not* able to shift the corporate tax to the consumer through higher prices and lower wages. Many research studies have shown a high degree of shifting of the corporate income tax, converting it into a consumption tax that is borne by the ultimate purchasers of goods.

The progressiveness of the Federal income tax rate structure for individuals has varied over the years. As late as 1986, for example, there were 15 rates, ranging from 0 to 50 percent. These later were reduced to two rates of 15 and 28 percent. Currently, there are six rates ranging from 10 to 35 percent.

1.2 Types of Taxes

LO.2

Identify the various taxes affecting business enterprises.

After taxes on income, the various transaction taxes usually play the most important role in business (and personal) contexts. In many countries, transaction taxes are even more important than income taxes. There are three types of transaction taxes: sales and certain **excise taxes**, employment taxes, and taxes on the transfer of wealth.

TAX in the NEWS

MORE EXCISE TAXES FROM THE FEDERAL GOVERNMENT—GOOD OR BAD?

The recent increase in the Federal excise tax on tobacco (from $0.39 to $1.01 per package of cigarettes) has met with a mixed reaction. On the positive side, the increase will fund a good cause—SCHIP (State Children's Health Insurance Program). Likewise, no one can take issue with a "sin tax" that purports to reduce smoking.

As for the negative aspects, most heavy smokers are lower-income taxpayers. Thus, this tax increase largely falls on the poor. Furthermore, various states have increased their tobacco taxes. Faced with a substantially higher cost for cigarettes, smokers who cannot kick the habit may see the cheaper price provided by an illegal market (i.e., smuggling) as an attractive alternative. Tax increases that foster criminal activity are not a good way to raise revenue.

More importantly, does this foray into tobacco taxes portend a new trend on the part of Congress to find new sources of revenue? Will other new excise taxes be imposed (e.g., a tax on soft drinks) or existing excise taxes increased (e.g., on alcoholic beverages)?

TAXES ON THE PRODUCTION AND SALE OF GOODS

Sales tax and some excise taxes are imposed on the production, sale, or consumption of commodities or the use of services. Excise taxes and general sales taxes differ by the breadth of their bases. An excise tax base is limited to a specific kind of good or service while a general sales tax is broad based (e.g., it might be levied on all retail sales). All levels of government impose excise taxes, while state and local governments make heavy use of the general sales tax.

Federal Excise Taxes

Together with customs duties, excise taxes served as the principal source of revenue for the United States during its first 150 years of existence. Since World War II, the role of excise taxes in the Federal government's fund-raising efforts has steadily declined, falling from about 30 to 40 percent of revenues just prior to the war to about 3 percent now. During this time, the Federal government came to rely upon income and employment taxes as its principal sources of funds.

Despite the decreasing contribution of excise taxes to the Federal coffers, they continue to have a significant impact on specific industries. Currently, trucks, trailers, tires, liquor, tobacco, firearms, certain sporting equipment, and air travel are all subject to Federal excise taxes. In the past, the sale and manufacture of a variety of other goods, including furs, jewelry, boats, luxury automobiles, and theater tickets, have been taxed. Excise taxes extend beyond sales transactions. They are also levied on privileges and rights, as discussed below.

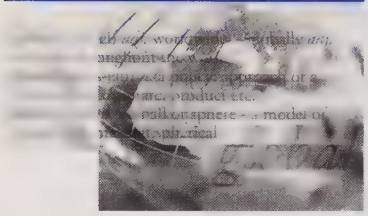
The bases used for Federal excise taxes are as diverse as the goods that are taxed. Fuels are taxed by the gallon, vaccines by the dose, telephone service and air travel by the price paid for the service, water travel by the passenger, coal by the ton extracted or by the sales price, insurance by the premiums paid, and the gas guzzler tax by the mileage rating on the automobile produced. Some of these taxes are levied on producers, some on resellers, and some on consumers. In almost every circumstance, the tax rate structure is proportional.

With the exception of Federal excise taxes on alcohol, tobacco, and firearms, Federal excise taxes are due at least quarterly, when the Federal excise tax return (Form 720) is filed.

State Excise Taxes

Many states levy excise taxes on the same items taxed by the Federal government. For example, most states have excise taxes on gasoline, liquor, and tobacco. However, the tax on specific goods can vary dramatically among states. Compare Rhode Island's $3.46 tax on each pack of cigarettes to South Carolina's $0.07 tax. These

GLOBAL
Tax Issues



Why Is Gasoline Expensive? It Depends on Where You Live

In recent years, increases in the cost of gasoline and fuel oil have sometimes aroused such a furor in the United States that supplies have been released from the national oil reserve. Whether such tactics reduce prices more than temporarily seems doubtful. But in the United States, unlike other countries, the price of gasoline largely is attributable to the cost of crude oil. In January 2010, the average price per gallon of gasoline in the United States was about $2.85.

In other countries, the real culprit is the amount of tax imposed. Consider the following situations.

Country	Price per Gallon (U.S. $)
United Kingdom	$6.73
Germany	7.37
France	7.07

While other factors may contribute to the higher European prices, the primary factor is the amount of tax charged in those countries. For example, in the United Kingdom, approximately 75 percent of the cost of gasoline is attributable to taxes.

differences at the state level provide ample incentive for smuggling between states and for state-line enterprises specializing in taxed goods.[2]

Other goods and services subject to state and local excise taxes include admission to amusement facilities, hotel occupancy, rental of other facilities, and sales of playing cards, oleomargarine products, and prepared foods. Most states impose a tax on transfers of property that require recording of documents (such as real estate sales and sales of stock and securities).

Local Excise Taxes

Over the last few years, two types of excise taxes imposed at the local level have become increasingly popular. These are the hotel occupancy tax and the rental car "surcharge." Since they tax the visitor who cannot vote, they are a political windfall and serve as a means of financing special projects that generate civic pride (e.g., convention centers, state-of-the-art sports arenas). That these levies can be significant is demonstrated by Houston's hotel tax of 17 percent and Kansas City's car rental taxes and fees totaling 35 percent.

General Sales Tax

The broad-based general sales tax is a major source of revenue for most state and local governments. It is used in all but five states (Alaska, Delaware, Montana, New Hampshire, and Oregon). While specific rules vary from state to state, the sales tax typically employs a proportional tax rate and includes retail sales of tangible personal property (and occasionally personal services) in the base. Some states exempt medicine and food from the base, and sometimes tax rates vary with the good being sold (e.g., the sales tax rate for automobiles may differ from the rate on other goods). The sales tax is collected by the retailer and then paid to the state government.

[2]Some excise taxes are referred to as "sin" taxes (because goods such as liquor and tobacco are subject to the tax). Although it is commonly believed that these taxes are imposed for the purpose of discouraging consumption, evidence frequently fails to show that sin taxes have a significant impact on consumption. Since demand for cigarettes and gasoline tends to be relatively inelastic (insensitive to price), the increase in price caused by excise taxes has little to do with rates of consumption.

Local general sales taxes, over and above those levied by the state, are common. It is not unusual to find taxpayers living in the same state who pay different general rates of sales taxes due to the location of their residence.

EXAMPLE 4

Pete and Sam both live in a state that has a general sales tax of 5%. Sam, however, resides in a city that imposes an additional general sales tax of 2%. Even though Pete and Sam live in the same state, one is subject to a rate of 5%, while the other pays a tax of 7%. ■

For various reasons, some jurisdictions suspend the application of a general sales tax. New York City occasionally does so to stimulate shopping. Illinois has permanently suspended the tax on construction materials used to build power-generating plants. Texas and many other jurisdictions do so annually on clothing right before the beginning of the school year. Such suspensions are similar to the tax holidays granted for ad valorem tax purposes.

Use Taxes

One obvious approach to avoiding state and local sales taxes is to purchase goods in a state that has little or no sales tax and then transport the goods back to one's home state. **Use taxes** exist to prevent this tax reduction ploy. The use tax is a value-based tax, usually imposed at the same rate as the sales tax, on the use, consumption, or storage of tangible property. Every state that imposes a general sales tax levied on the consumer also applies a use tax.

EXAMPLE 5

Orange, Inc., is located in a jurisdiction that imposes a 5% general sales tax, but is located near a state that has no sales or use tax. Orange purchases an automobile for $50,000 from a dealer located in the neighboring tax-free state. Though Orange will pay no sales tax to the dealer upon purchase of the car, it will be assessed a use tax when it brings the automobile back to its home state and licenses it. ■

The use tax is difficult to enforce for many other purchases and therefore is often avoided. In some cases, for example, it may be worthwhile to make purchases through an out-of-state mail-order or Internet business. In spite of shipping costs, the avoidance of the local sales tax that otherwise might be incurred often makes the price of such products as computer components cheaper. Most of the states are taking steps to curtail this loss of revenue.

Value Added Tax

The **value added tax (VAT)** is a sales tax levied at each stage of production on value added by the producer. VAT is in widespread use in many countries around the world (most notably in the European Union and in Canada). The tax typically serves as a major source of revenue for governments that use it.[3]

EXAMPLE 6

Farmer Brown sells wheat to a flour mill for $100. If the wheat cost $65 for Brown to produce and if the VAT rate is 10%, then Brown will owe a VAT of $3.50 [0.10($100 − $65)]. If the mill sells the flour for $200 to a baker and if it cost the mill $120 to make the flour (including the cost of Brown's wheat), then it will pay a VAT of $8 [0.10($200 − $120)]. If the baker sells the bread he makes from the flour for $400 and if it cost the baker $280 to make the bread, then he will pay a VAT of $12 [0.10($400 − $280)]. The consumer who buys the bread will not pay any VAT directly. It is likely, however, that some or all of the total VAT paid of $23.50 ($3.50 + $8 + $12) will be paid by the consumer in the form of higher prices for the bread. ■

[3]Some proposals to reduce the Federal government's reliance on the employment and income taxes have focused on VAT as an alternative tax system.

EMPLOYMENT TAXES

Both Federal and state governments tax the salaries and wages paid to employees. On the Federal side, employment taxes represent a major source of funds. For example, the **FICA tax** accounts for more than one-third of revenues in the Federal budget, second only to the income tax in its contribution.

The Federal government imposes two kinds of employment tax. The Federal Insurance Contributions Act (FICA) imposes a tax on self-employed individuals, employees, and employers. The proceeds of the tax are used to finance Social Security and Medicare benefits. The Federal Unemployment Tax Act (FUTA) imposes a tax on employers only. The **FUTA tax** provides funds to state unemployment benefit programs. Most state employment taxes are similar to the FUTA tax, with proceeds used to finance state unemployment benefit payments.

FICA Taxes

The FICA tax has two components: old age, survivors, and disability insurance payments (commonly referred to as Social Security) and Medicare health insurance payments. The Social Security tax rate is 6.2 percent, and the Medicare tax rate is 1.45 percent. The maximum base for the Social Security tax is $106,800 for 2010. There is no ceiling on the base amount for the Medicare tax. The employer must withhold the FICA tax from an employee's wages and must also pay a matching tax.

Payments usually are made through weekly or monthly electronic payments or deposits to a Federal depository. Employers must also file Form 941, Employer's Quarterly Federal Tax Return, by the end of the first month following each quarter of the calendar year (e.g., by July 31 for the quarter ending on June 30) and pay any remaining amount of employment taxes due for the previous quarter. Failure to pay can result in large and sometimes ruinous penalties.

EXAMPLE 7

Janet receives $120,000 in salary in 2010. She pays FICA taxes of $8,362 [(7.65% × $106,800) + 1.45%($120,000 − $106,800)]. Her employer is required to pay a matching FICA tax of $8,362. Janet's share of FICA taxes is withheld from her salary by her employer and deposited on a regular basis together with the employer's share of FICA. ■

Finally, FICA tax is not assessed on all wages paid. For example, wages paid to children under the age of 18 who are employed in a parent's trade or business are exempt from the tax.

Self-Employment Tax

Self-employed individuals also pay FICA in the form of a self-employment (SE) tax (determined on Schedule SE, filed with Form 1040, U.S. Individual Income Tax Return). Self-employed individuals are required to pay both the employer and the employee portion of the FICA tax. Therefore, the 2010 SE tax rate is 15.3 percent (2 × 7.65%) on self-employment income up to $106,800 and 2.9 percent (2 × 1.45%) on all additional self-employment income. Self-employed individuals deduct half of the SE tax—the amount normally deductible by an employer as a business expense. Self-employment income is discussed in more detail in Chapter 17.

Unemployment Taxes

In 2010, FUTA applies at a rate of 6.2 percent on the first $7,000 of covered wages paid during the year to each employee. As with FICA, this represents a regressive rate structure. The Federal government allows a credit for unemployment tax paid (or allowed under a merit rating system)[4] to the state. The credit cannot exceed 5.4

[4]States follow a policy of reducing unemployment tax on employers with stable employment. Thus, an employer with no employee turnover might face state unemployment tax rates as low as 0.1% or, in some cases, zero. This *merit rating system* explicitly accounts for the savings generated by steady employment.

percent of the covered wages. Thus, the amount required to be paid to the IRS could be as low as 0.8 percent (6.2% − 5.4%).

FUTA and state unemployment taxes differ from FICA in that the tax is imposed only on the employer. A few states, however, levy a special tax on employees to provide either disability benefits or supplemental unemployment compensation, or both.

Employers file Form 940, Employer's Annual Federal Employment Tax Return, to determine the amount of Federal unemployment taxes due in a given year. The return is due on or before January 31 of the following year.[5] Most states also require unemployment tax returns to be filed with quarterly estimated payments.

TAXES AT DEATH

The transfer of property upon the death of the owner may be a taxable event. If the tax is imposed on the transferor at death, it is called an **estate tax**. If it taxes the recipient of the property, it is termed an **inheritance tax**. As is typical of other types of transaction taxes, the value of the property transferred provides the base for determining the amount of the tax at death.

The Federal government imposes only an estate tax. State governments, however, levy inheritance taxes, estate taxes, or both. Some states (e.g., Florida, Texas) levy neither tax.

EXAMPLE 8

At the time of her death, Wilma lived in a state that imposes an inheritance tax but not an estate tax. Mary, one of Wilma's heirs, lives in the same state. Wilma's estate is subject to the Federal estate tax, and Mary is subject to the state inheritance tax. ■

The Federal Estate Tax

Never designed to generate a large amount of revenue, the Federal estate tax was originally intended to prevent large concentrations of wealth from being kept within a family for many generations. Whether this objective has been accomplished is debatable, because estate taxes can be substantially reduced (or deferred for decades) through careful tax planning activities.

Determination of the estate tax base begins with the *gross estate*, which includes property the decedent owned at the time of death. It also includes property interests, such as life insurance proceeds paid to the estate or to a beneficiary other than the estate if the deceased-insured had any ownership rights in the policy. Most property included in the gross estate is valued at fair market value as of the date of death.

Deductions from the gross estate in arriving at the *taxable estate* include funeral and administration expenses, certain taxes, debts of the decedent, transfers to charitable organizations, and, in some cases, an unlimited marital deduction. The *marital deduction* is available for amounts actually passing to a surviving spouse (a widow or widower).

Once the taxable estate has been determined and certain taxable gifts have been added to it, progressive estate tax rates ranging from 18 to 45 percent in 2009 are applied to determine a tentative tax liability. The tentative liability is reduced by a variety of credits to arrive at the amount due. Although many credits are available, probably the most significant is the *unified transfer tax credit*. This credit eliminates estate tax liability for most individuals. For 2009, the amount of the credit is $1,455,800. Based on the estate tax rates, the credit exempts a tax base of $3.5 million.

EXAMPLE 9

Ildiko made no taxable gifts before her death in 2009. If Ildiko's taxable estate amounts to $3.5 million or less, no Federal estate tax is due because of the application of the unified transfer tax credit. Under the tax law, the tentative estate tax on a taxable estate of $3.5 million is $1,455,800, exactly equal to the maximum unified transfer tax credit allowed. ■

[5]Employers may be required to make more frequent payments of the tax (estimated payments) if their FUTA liability is sufficiently large.

State Taxes at Death

States usually levy an inheritance tax, an estate tax, or both. The two forms of tax differ according to whether the liability is imposed on the heirs or on the estate.

Characteristically, an inheritance tax divides the heirs into classes based on their relationship to the decedent. The more closely related the heir, the lower the rates imposed and the greater the exemption allowed. Some states completely exempt amounts passing to a surviving spouse from taxation.

GIFT TAXES

Like estate and inheritance taxes, the gift tax is an excise tax levied on the right to transfer property. In this case, however, the tax is imposed on transfers made during the owner's life rather than at death. A gift tax applies only to transfers that are not supported by full and adequate consideration (i.e., gifts).

EXAMPLE 10

Carl sells property worth $20,000 to his daughter for $1,000. Although property worth $20,000 has been transferred, only $19,000 represents a gift, since this is the portion not supported by full and adequate consideration. ■

The Federal Gift Tax

The Federal gift tax is intended to complement the estate tax. The gift tax base is the sum of all taxable gifts made *during one's lifetime.* Gifts are valued at the date of transfer. To compute the tax due in a year, the tax rate schedule is applied to the sum of all lifetime taxable gifts. The resulting tax is then reduced by gift taxes paid in prior years.

EXAMPLE 11

In 1995, Willie gave $700,000 of taxable gifts to his son. The gift tax paid in 1995 (before application of any credits) was $229,800. In 2010, Willie gives an additional $100,000 in taxable gifts to his son. The tax base in 2010 is $800,000 of lifetime gifts, and the tax is $267,800. However, the actual gift tax due for 2010 (before credits) is $38,000 ($267,800 − $229,800 tax paid on prior-year gifts). ■

Under current law, the Federal gift tax and the Federal estate tax are *unified.*[6] The transfer of assets by a decedent at death is effectively treated as a final gift under the tax law. Thus, the unified transfer tax credit available under the estate tax is also available to reduce the tax liability generated by lifetime gifts. If the credit is exhausted during one's lifetime, it is not available to reduce the estate tax liability, except to the extent of the excess of the credit amount for estate tax purposes over that for gift tax purposes. In addition, the same tax rate schedule applies to both lifetime gifts and the estate tax.

EXAMPLE 12

Before his death, Ben gives $1 million of taxable gifts. Because the unified transfer tax credit was used during his life to offset the tax due on these gifts, only a partial credit is left to reduce Ben's estate tax liability. ■

Annual taxable gifts are determined by reducing the fair market value of gifts given by an *annual exclusion* of $13,000 per donee. A married couple can elect *gift splitting,* which enables them to transfer twice the annual exclusion ($26,000) per donee per year.

The Federal gift tax uses a unified transfer tax credit that is frozen at $345,800, which exempts a taxable gift of $1 million.

[6] §§ 2010 and 2505.

TAX in the News

The Backdoor Tax Increase

Can a landowner's property taxes increase even though the tax rate has not changed? Yes, if the assessed value of the property is increased! Known as a "backdoor tax increase," this procedure allows the taxing authority to generate additional revenue without having to secure voter approval for an increase in the tax rate. Even more aggravating for the property owner is an increase in assessed value that is based on past market values and does not reflect the true current value. This kind of increase often occurs during periods of economic downturn, i.e., when real estate prices decline. Under these conditions, increases in assessed value are likely to cause considerable taxpayer dissatisfaction and lead to proposals for legislative relief, such as a freeze on upward property assessments.

EXAMPLE 15

On December 31, 2010, Vera (a widow) gives $13,000 to each of her four married children, their spouses, and her eight grandchildren. On January 3, 2011, she repeats the procedure. Due to the annual exclusion, Vera has *not* made a taxable gift, although she transferred $208,000 [$13,000 × 16 (the number of donees)] in 2010 and $208,000 [$13,000 × 16 (the number of donees)] in 2011 for a total of $416,000 ($208,000 + $208,000). If Vera were married, she could have given twice as much ($832,000) by electing gift splitting with her husband. ■

Unlike death, which is involuntary, the making of a gift is a voluntary parting of ownership. Thus, the ownership of a business can be transferred gradually without incurring drastic and immediate tax consequences.

State Gift Taxes

The states currently imposing a gift tax are Connecticut, Louisiana, North Carolina, and Tennessee. Most of the laws provide for lifetime exemptions and annual exclusions. Unlike the Federal version, the amount of state gift tax often depends on the relationship between the donor and the donee. As with state inheritance taxes, larger exemptions and lower rates apply when the donor and donee are closely related to each other.

PROPERTY TAXES

A property tax can be a tax on the ownership of property or a tax on wealth, depending on the base used. Any measurable characteristic of the property being taxed can be used as a base (e.g., weight, size, number, or value). Most property taxes in the United States are taxes on wealth; they use value as a base. These value-based property taxes are known as **ad valorem taxes**. Property taxes are generally administered by state and local governments, where they serve as a significant source of revenue.

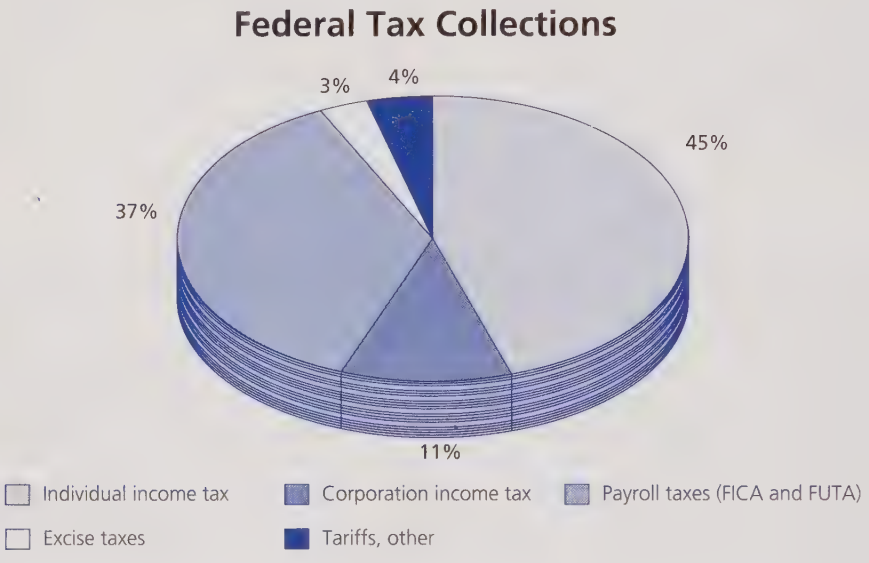
Taxes on Realty

Property taxes on **realty** are used exclusively by states and their local political subdivisions such as cities, counties, and school districts. They represent a major source of revenue for local governments, but their importance at the state level is limited.

How realty is defined can have an important bearing on which assets are subject to tax. This is especially true in jurisdictions that do not impose ad valorem taxes on **personalty**. Realty generally includes real estate and any capital improvements that are classified as fixtures. A fixture is something so permanently attached to the real estate that its removal will cause irreparable damage. A built-in bookcase might be a fixture, whereas a movable bookcase is not. Certain items such as electrical wiring and plumbing change from personalty to realty when installed in a building.

A Profile of Tax Collections

Federal budget receipts for fiscal 2010 indicate a dependence by the government on payroll and individual income taxes. Corporate income tax collections likely are far below what the general public might estimate.



The following are some of the characteristics of ad valorem taxes on realty.

- Property owned by the Federal government is exempt from tax. Similar immunity usually is extended to property owned by state and local governments and by certain charitable organizations.
- Some states provide for lower valuations on property dedicated to agricultural use or other special uses (e.g., wildlife sanctuaries).
- Some states partially exempt the homestead, or personal residence, portion of property from taxation. Additionally, modern homestead laws normally protect some or all of a personal residence (including a farm or ranch) from the actions of creditors pursuing claims against the owner.
- Lower taxes may apply to a residence owned by a taxpayer age 65 or older.
- Some jurisdictions extend immunity from tax for a specified period of time (a tax holiday) to new or relocated businesses.

Taxes on Personalty

Personalty includes all assets that are not realty. It may be helpful to distinguish between the classification of an asset (realty or personalty) and the use to which it is put. Realty and personalty can be either business-use or personal-use property. Examples include a residence (personal-use realty), an office building (business-use realty), surgical instruments (business-use personalty), and casual clothing (personal-use personalty).

Personalty can also be classified as tangible property or intangible property. For property tax purposes, intangible personalty includes stocks, bonds, and various other securities (e.g., bank shares).



What Is the U.S. Tax Burden?

One popular measure of the burden of taxes in the U.S. economy is the Tax Foundation's "Tax Freedom Day." This statistic is a determination of the day upon which an individual has completed the entire year's obligation to governmental units (i.e., if all earnings were paid as taxes to this point, annual taxes would be paid up, and one would now begin to "work for your own account").

Being "free from taxes" may bring about a feeling of relief, but in reality tax burdens vary greatly from state to state. And as the U.S. economy has evolved and develops a more complex tax structure, adding emphasis on income and sales/use taxes, and reducing the relative reliance on tariffs and excise taxes, year-to-year comparisons become difficult. Nonetheless, as a rough measure of the presence of government in our lives, Tax Freedom Day carries some importance.

Year	Tax Freedom Day
1902	1/31
1930	2/12
1945	4/4
1960	4/15
1970	4/26
1990	5/1
1999	5/11
2000	5/3
2005	4/17
2008	4/13

The following generalizations may be made concerning the property taxes on personalty.

- Particularly with personalty devoted to personal use (e.g., jewelry, household furnishings), taxpayer compliance ranges from poor to zero. Some jurisdictions do not even attempt to enforce the tax on these items. For automobiles devoted to personal use, many jurisdictions have converted from value as the tax base to a tax based on the weight of the vehicle. Some jurisdictions also consider the vehicle's age (e.g., automobiles six years or older are not subject to the ad valorem tax because they are presumed to have little value).
- For personalty devoted to business use (e.g., inventories, trucks, machinery, equipment), taxpayer compliance and enforcement procedures are notably better.
- Some jurisdictions impose an ad valorem property tax on intangibles.

TAXES ON PRIVILEGES AND RIGHTS

Taxes on privileges and rights are usually considered excise taxes. A few of the most important of these taxes are reviewed here.

Federal Customs Duties

Customs duties or tariffs can be characterized as a tax on the right to move goods across national borders. These taxes, together with selective excise taxes, provided most of the revenues needed by the Federal government during the nineteenth century. For example, tariffs and excise taxes alone paid off the national debt in 1835

and enabled the U.S. Treasury to pay a surplus of $28 million to the states. Today, however, customs duties account for only 1 percent of revenues in the Federal budget.

In recent years, tariffs have acted more as an instrument for carrying out protectionist policies than as a means of generating revenue. Thus, a particular U.S. industry might be saved from economic disaster, so the argument goes, by placing customs duties on the importation of foreign goods that can be sold at lower prices. Protectionists contend that the tariff therefore neutralizes the competitive edge held by the producer of the foreign goods.[7]

Protectionist policies seem more appropriate for less-developed countries whose industrial capacity has not yet matured. In a world where a developed country should have everything to gain by encouraging international free trade, such policies may be of dubious value since tariffs often lead to retaliatory action on the part of the nation or nations affected.

Franchise Taxes and Occupational Taxes

A **franchise tax** is a tax on the privilege of doing business in a state or local jurisdiction. Typically, the tax is imposed by states on corporations, but the tax base varies from state to state. While some states use a measure of corporate net income as part of the base, most states base the tax on the capitalization of the corporation (with or without certain long-term debt).

Closely akin to the franchise tax are **occupational taxes** applicable to various trades or businesses, such as a liquor store license, a taxicab permit, or a fee to practice a profession such as law, medicine, or accounting. Most of these are not significant revenue producers and fall more into the category of licenses than taxes. The revenue derived is used to defray the cost incurred by the jurisdiction to regulate the business or profession for the public good.

Severance Taxes

Severance taxes are based on the extraction of natural resources (e.g., oil, gas, iron ore, and coal). They are an important source of revenue for many states (e.g., Alaska).

INCOME TAXES

Income taxes are levied by the Federal government, most states, and some local governments. In recent years, the trend in the United States has been to place greater reliance on this method of taxation while other countries are relying more heavily on transactions taxes such as the VAT.

Income taxes are generally imposed on individuals, corporations, and certain fiduciaries (estates and trusts). Most jurisdictions attempt to assure the collection of income taxes by requiring certain pay-as-you-go procedures, including withholding requirements for employees and estimated tax prepayments for all taxpayers.

LO.3

Recall the basic tax formula for individuals and taxable business entities.

The Structure of the Federal Income Tax

Although some variations exist, the basic Federal income tax formula is similar for all taxable entities. This formula is shown in Figure 1.1.

The income tax is based on the assumption that all income is subject to tax and that no deductions are allowed unless specifically provided for in the law. Some types of income are specifically excluded on the basis of various economic, social, equity, and political considerations. Examples include gifts, inheritance, life insurance proceeds received by reason of death, and interest income from state and local bonds. All entities are allowed to deduct business expenses from gross income, but a

[7]The North American Free Trade Agreement (NAFTA) substantially reduces the tariffs on trade between Canada, Mexico, and the United States. General Agreement on Tariffs and Trade (GATT) legislation reduced tariffs on selected commodities among 124 countries.

FIGURE 1.1 Basic Formula for Federal Income Tax

Income (broadly conceived)	$xxx,xxx
Less: Exclusions (income that is not subject to tax)	(xx,xxx)
Gross income (income that is subject to tax)	$xxx,xxx
Less: Deductions	(xx,xxx)
Taxable income	$xxx,xxx
Federal income tax on taxable income (see Tax Rate Schedules inside front cover of text)	$ xx,xxx
Less: Tax credits (including Federal income tax withheld and other prepayments of Federal income taxes)	(x,xxx)
Tax owed (or refund)	$ xxx

number of limitations and exceptions are applied. A variety of credits against the tax are also allowed, again on the basis of economic, social, equity, or political goals of Congress.

Income tax rates for all entities are progressive. The corporate rates range from 15 percent on the lowest level of taxable income to 35 percent on the highest level. Individual rates range from 10 percent to 35 percent. Estates and trusts are also subject to taxation, with rates ranging from 15 percent to 35 percent.

Partnerships, qualifying small business corporations, and some limited liability companies are not taxable entities, but must file information returns. Owners of these business entities then are taxed on the net taxable income of the enterprise, proportionate to their holdings.

For individuals, deductions are separated into two categories—deductions *for* adjusted gross income (AGI) and deductions *from* AGI. Generally, deductions *for* AGI are related to business activities, while deductions *from* AGI often are personal in nature (e.g., medical expenses, mortgage interest and property taxes on a personal residence, charitable contributions, and personal casualty losses) or related to investment activities. Deductions *from* AGI take the form of *itemized deductions* and personal and dependency exemptions. Individuals may take a *standard deduction* (a specified amount based on filing status) rather than itemizing actual deductions. An overview of the individual income tax formula is provided in Figure 1.2.

FIGURE 1.2 Federal Income Tax Formula for Individuals

Income (broadly conceived)	$xx,xxx
Less: Exclusions (income that is not subject to tax)	(x,xxx)
Gross income (income that is subject to tax)	$xx,xxx
Less: Certain business and investment deductions (usually referred to as deductions *for* adjusted gross income)	(x,xxx)
Adjusted gross income	$xx,xxx
Less: The greater of certain personal and employee deductions (usually referred to as *itemized deductions*)	
or	
The standard deduction (including any *additional* standard deduction)	(x,xxx)
Less: Personal and dependency exemptions	(x,xxx)
Taxable income	$xx,xxx
Federal income tax on taxable income (see Tax Rate Schedules inside front cover of text)	$ x,xxx
Less: Tax credits (including Federal income tax withheld and other prepayments of Federal income taxes)	(xxx)
Tax owed (or refund)	$ xxx



Bridge to Political Science and Sociology

The tax law and its effects on citizens and businesses of the United States are included in many other academic disciplines. Tax burdens are part of American fiction, family studies, and minority issues, as well as economics, finance, and management courses.

In the Bridge feature found in most chapters of this text, we relate the concerns of other disciplines to a more specific review of tax law, as presented here. With the topical knowledge obtained in this text, the reader can better understand the issues raised by other disciplines, sometimes to support beliefs held by others, and sometimes to refute them.

For instance, the structure of the U.S. tax system raises many issues of equity and fairness. Politicians and journalists discuss these issues freely, often without the requisite tax knowledge to draw proper conclusions.

- Should the property tax on real estate be used to finance the local public education system? Why should elderly taxpayers with grown children, or parents who send their children to private schools, continue to pay for public schools through these taxes?
- How will the repeal of the Federal estate tax affect legacy gifts made to charitable organizations? Would the lack of a charitable contribution deduction impair the ability of charities to raise operating and capital funds?
- Does a regressive sales/use tax fall harder on individuals of color?



In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

State Income Taxes

Most states (except Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming) impose a traditional income tax on individuals. Tennessee taxes only income from stocks and bonds, and New Hampshire taxes only dividend and interest income. Most states also impose either a corporate income tax or a franchise tax based in part on corporate income. The following additional points can be made about state income taxes.

- State income tax usually relies on Federal income tax laws to some degree—the states use Federal taxable income as a base, with a few adjustments (e.g., a few allow a deduction for Federal income taxes paid and sometimes an exclusion on interest income earned on Federal securities).
- For individuals, a few states impose a flat rate on Federal AGI.
- Several states piggyback directly on the Federal income tax system by using the Federal income tax liability as a tax base.
- Most states also require withholding of state income tax from salaries and wages and estimated payments by corporations and self-employed individuals.
- Most states have their own set of rates, exemptions, and credits.
- Many states also allow a credit for taxes paid to other states.
- Virtually all state income tax returns provide checkoff boxes for donations to various causes. Many are dedicated to medical research and wildlife programs, but special projects are not uncommon. For example, Oklahoma uses a checkoff to retire the debt incurred for its new capitol dome, while a Wisconsin checkoff financed part of the renovation of Lambeau Field (home of the Green Bay Packers). These checkoff boxes have been criticized as adding complexity to the returns (e.g., one state has 24 boxes) and misleading taxpayers.

TAX in the NEWS

Using the Income Tax Return as a "Use Tax" Reminder

Many consumers do not pay state and local sales tax on out-of-state purchases made online or through mail-order catalogs. In such cases, the consumer has an obligation to pay the taxing authority an equivalent amount of use tax to the taxing jurisdiction. Because the use tax often is not paid, either inadvertently or deliberately, some states are resorting to less subtle enforcement measures.

New York has added a separate line on its income tax return for the reporting of use taxes. The line cannot be left blank—either an amount *or* a notation of "zero" must be entered. The taxpayer should list the actual amount due *or* an estimate based on a table. The table is prepared by the state and reflects the likely amount of Internet purchases for various income levels.

Local Income Taxes

Cities imposing an income tax include Baltimore, Cincinnati, Cleveland, Columbus, Detroit, Kansas City (Mo.), New York, Philadelphia, and St. Louis. City income taxes usually apply to anyone who earns income in a city. They are designed to collect contributions for government services from those who live in the suburbs but work in the city as well as from local residents.

1.3 Income Taxation of Business Entities

LO.4

Understand the relationship between business entities and their owners.

PROPRIETORSHIPS

The simplest form of business entity is a **proprietorship**, which is not a separate taxable entity. Instead, the proprietor reports the net profit of the business on his or her own individual tax return.

Individuals who own proprietorships often have specific tax goals with regard to their financial interactions with the business. Because a proprietorship is, by definition, owned by an individual, the individual has great flexibility in structuring the entity's transactions in a way that will minimize his or her income tax (or, in some cases, the income tax of the family unit).

EXAMPLE 24

Susan, a single individual, is the sole proprietor of Quality Fabrics, a retail store in which she works full-time. The business is her only source of income. Susan's taxable income in 2010 is $100,000, and her Federal income tax is $21,709.25 ($16,781.25 + 28% of the amount over $82,400). Thus, her *marginal tax rate*[8] is 28%. ■

EXAMPLE 25

Assume the same facts as in the previous example, except that Susan pays Butch, her nondependent 19-year-old son, a $10,000 salary to work part-time at Quality Fabrics. This reduces her 2010 taxable income by $10,000 and her tax bill by $2,800 ($10,000 deduction × 28% marginal tax rate).

Butch reports $650 in taxable income ($10,000 − $5,700 standard deduction − $3,650 personal exemption), and he is taxed at a 10% rate, which results in Federal income tax of $65.

In summary, Susan (the individual taxpayer) can operate the business entity (Quality Fabrics) in a way that will save the family unit $2,735 in Federal income tax ($2,800 saved by Susan − $65 paid by Butch). ■

[8]A taxpayer's *marginal tax rate* (or *marginal tax bracket*) is the rate that would be paid on an additional dollar of taxable income.

Examples 14 and 15 reflect the fact that a proprietorship itself is not a taxpaying entity. The owner of the proprietorship must report the income and deductions of the business on a Schedule C (Profit or Loss from Business) and must report the net profit (or loss) of the proprietorship on his or her Form 1040 (U.S. Individual Income Tax Return). Specific issues related to the taxation of sole proprietorships are presented in detail in Chapter 17.

CORPORATIONS

Some corporations pay tax on corporate taxable income while others pay no tax at the corporate level. Corporations that are separate taxable entities are referred to as **C corporations**, because they are governed by Subchapter C of the Internal Revenue Code. Corporations that meet certain requirements and pay no tax at the corporate level are referred to as **S corporations**, because they are governed by Subchapter S of the Code. S corporations are discussed in detail in Chapter 12. C corporations are addressed in Chapters 9 and 10.

A C corporation is required to file a tax return (Form 1120) and is subject to the Federal income tax. The shareholders then pay income tax on the dividends they receive when the corporation distributes its profits. Thus, the profits of the corporation can be seen as subject to double taxation, first at the corporate level and then at the shareholder level.

EXAMPLE 16

Joseph is single, has no dependents, and does not itemize deductions. He is the president and sole shareholder of Falcon Corporation. Falcon's taxable income is $100,000, and its tax liability is $22,250. If Joseph has the corporation pay all of its after-tax income to him as a dividend, he will receive $77,750, report taxable income of $68,400 (after the $5,700 standard deduction and $3,650 personal exemption), and pay Federal income tax of $10,260 ($68,400 × 15% rate for qualified dividends). The combined Federal income tax paid by Joseph and the corporation is $32,510 ($22,250 corporate tax + $10,260 individual tax). ■

PARTNERSHIPS

A partnership is not a separate taxable entity. The partnership is required to file a tax return (Form 1065) on which it summarizes the financial results of the business. Each partner then reports his or her share of the net income or loss and other special items that were reported on the partnership return.

EXAMPLE 17

Cameron and Connor form a partnership in which they are equal partners. The partnership reports a $100,000 net profit on its tax return, but is not subject to the Federal income tax. Cameron and Connor each report $50,000 net income from the partnership on their separate individual income tax returns. ■

S CORPORATIONS

An S corporation is like a C corporation for all nontax purposes. Shareholders have limited liability, shares are freely transferable, there is a centralized management (vested in the board of directors), and there is continuity of life (i.e., the corporation continues to exist after the withdrawal or death of a shareholder).

With regard to tax factors, however, an S corporation is more like a partnership. The S corporation is not subject to the Federal *income tax*. Like a partnership, it does file a tax return (Form 1120S), but the shareholders report their share of net income or loss and other special items on their own tax returns.

EXAMPLE 18

Kay and Dawn form a corporation and elect to treat it as an S corporation. Kay owns 60% of the stock of the corporation, and Dawn owns 40%. The S corporation reports a

$100,000 net profit on its tax return, but is not subject to the income tax. Kay reports $60,000 net income from the S corporation on her individual income tax return, and Dawn reports $40,000 on her tax return. ■

LIMITED LIABILITY COMPANIES AND LIMITED LIABILITY PARTNERSHIPS

Limited liability companies (LLCs) and limited liability partnerships (LLPs) offer limited liability and some (but not all) of the other nontax features of corporations. Both forms usually are treated as partnerships for tax purposes.

The S corporation, limited liability company, and partnership forms of organization, which are referred to as *flow-through* entities, avoid the double taxation problem associated with the C corporation.

DEALINGS BETWEEN INDIVIDUALS AND ENTITIES

Many of the provisions in the tax law deal with the relationships between owners and the business entities they own. The following are some of the major interactions between owners and business entities.

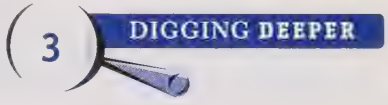
- Owners put assets into a business when they establish a business entity (e.g., a proprietorship, partnership, or corporation).
- Owners take assets out of the business during its existence in the form of salary, dividends, withdrawals, redemptions of stock, etc.
- Through their entities, owner-employees set up retirement plans for themselves, including IRAs, Keogh plans, and qualified pension plans.
- Owners dispose of all or part of a business entity.

Every major transaction that occurs between an owner and a business entity has important tax ramifications. The following are a few of the many tax issues that arise.

- How to avoid taxation at both the owner level and the entity level (i.e., the multiple taxation problem).
- How to get assets into the business with the least adverse tax consequences.
- How to get assets out of the business with the least adverse tax consequences.
- How to dispose of the business entity with the least adverse tax consequences.

When addressing these (and other) tax issues, a common set of tax planning tools can be applied. These tax planning fundamentals are introduced in the next section.

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.



1.4 TAX PLANNING FUNDAMENTALS

OVERVIEW OF TAX PLANNING

LO.5

Recognize tax planning opportunities and apply a general framework for tax planning.

Taxpayers generally attempt to minimize their tax liabilities, and it is perfectly acceptable to do so by using legal means. It is a long-standing principle that taxpayers have no obligation to pay more than their fair share of taxes. The now-classic words of Judge Learned Hand in *Commissioner v. Newman* reflect the true values a taxpayer should have.

> Over and over again courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands; taxes are enforced exactions, not voluntary contributions. To demand more in the name of morals is mere cant.[9]

Minimizing taxes legally is referred to as **tax avoidance**. On the other hand, some taxpayers attempt to *evade* income taxes through illegal actions. There is a major distinction between tax avoidance and **tax evasion**. Though eliminating or reducing taxes is also a goal of tax evasion, the term *evasion* implies the use of subterfuge and fraud as a means to this end. Tax avoidance is legal, while tax evasion subjects the taxpayer to numerous civil and criminal penalties, including prison sentences.

Clients expect tax practitioners to provide advice to help them minimize their tax costs. This part of the tax practitioner's practice is referred to as *tax planning*. To structure a sound tax minimization plan, a practitioner must have a thorough knowledge of the tax law. Tax planning skill is based on knowledge of tax saving provisions in the tax law, as well as provisions that contain costly pitfalls for the unwary. Thorough study of the remainder of this text will provide a solid base of the knowledge required to recognize opportunities and avoid pitfalls. Tax planning requires the practitioner to have in mind both a framework for planning and an understanding of the tax planning implications of a client's situation.

★ Tax Planning Framework

A GENERAL FRAMEWORK FOR INCOME TAX PLANNING

The primary goal of tax planning is to design a transaction so as to minimize its tax costs, while meeting the other nontax objectives of the client. Generally, this means that the client attempts to maximize the present value of its after-tax income and assets. Selecting a specific form of transaction solely for the sake of tax minimization often leads to a poor business decision. Effective tax planning requires careful consideration of the nontax issues involved in addition to the tax consequences.

Careful analysis of the tax formula (refer to Figure 1.1) reveals a series of tax minimization strategies. Through creative tax planning that also takes into consideration a client's nontax concerns, each component of the tax formula can be managed in a way that will help to minimize the client's tax liability. The General Framework for Income Tax Planning in Figure 1.3 lists each element in the income tax formula, develops tax planning strategies designed to minimize taxes, and provides brief summaries of specific examples of tax planning. The framework is followed by a discussion of the tax planning strategies, along with detailed examples of how the strategies can be applied. In Chapters 4 through 17 of this book, these strategies and their tax formula components provide the framework for Tax Planning Strategies features.

★ Framework Focus: Income

➤ *Tax Planning Strategy*

TAX MINIMIZATION STRATEGIES RELATED TO INCOME

➤*Avoid Income Recognition.* Section 61(a) defines gross income as "all income from whatever source derived." However, the Code contains provisions that allow various types of income to be excluded from the tax base. Numerous exclusions are available for individuals, but very few are available for corporations. However, a corporation can provide excludible income for its owners at no tax cost to the corporation.

EXAMPLE 15

The average employee of Penguin Corporation is a 25% bracket taxpayer. In negotiations with the employees' union, Penguin proposes that it will increase the amount it spends on nontaxable fringe benefits by an average of $3,000 per employee in lieu of

[9] 47–1 USTC ¶9175, 35 AFTR 857, 159 F.2d 848 (CA–2, 1947).

FIGURE 1.3 General Framework for Income Tax Planning

Tax Formula	Tax Planning Strategy	Tax Planning Examples
Income and exclusions	➢ **Avoid income recognition.**	Compensate employees with nontaxable fringe benefits (see Example 19).
	➢ **Postpone recognition of income to achieve tax deferral.**	Postpone sale of assets (see Example 20).
−Deductions	➢ **Maximize deductible amounts.**	Invest in stock of another corporation (see Example 21).
	➢ **Accelerate recognition of deductions to achieve tax deferral.**	Elect to deduct charitable contribution in year of pledge rather than in year of payment (see Example 22).
= Taxable income		
×Tax rate	➢ **Shift net income from high-bracket years to low-bracket years.**	Postpone recognition of income to a low-bracket year (see Example 23).
		Postpone recognition of deductions to a high-bracket year (see Example 24).
	➢ **Shift net income from high-bracket taxpayers to low-bracket taxpayers.**	Pay children to work in the family business (see Example 25).
	➢ **Shift net income from high-tax jurisdictions to low-tax jurisdictions.**	Establish subsidiary operations in countries with low tax rates (see Examples 26 and 27).
	➢ **Control the character of income and deductions.**	Hold assets long enough to qualify for long-term capital gain rates before selling them (see Example 28).
		Invest in small business stock to obtain ordinary loss treatment under § 1244 (see Example 29).
	➢ **Avoid double taxation.**	Operate as a flow-through entity rather than a C corporation (see Example 30).
		Maximize deductible expenses paid by a C corporation to a shareholder/employee (see Example 31).
= Federal income tax		
−Tax credits	➢ **Maximize tax credits.**	Hire employees who qualify the business for the work opportunity tax credit (see Example 33).
= Tax owed (or refund)		

granting a $3,000 average salary increase. The average employee will be better off by $750 if the union accepts Penguin's offer.

	Salary Increase	Fringe Benefit Increase
Value of compensation received	$3,000	$3,000
Tax on employee's compensation	(750)	(–0–)
After-tax increase in compensation	$2,250	$3,000

Although the average employee receives a $750 benefit, there is no tax cost to Penguin because both fringe benefits and salaries are deductible by the corporation. ■

➤ ***Postpone Recognition of Income to Achieve Tax Deferral.*** The tax law requires that both income and expenses be reported in the proper tax year. If not for this requirement, taxpayers could freely shift income and expenses from year to year to take advantage of tax rate differentials or could defer tax liabilities indefinitely. Although various rules limit the shifting of income and deductions across time periods, some opportunities still exist.

➤ *Tax Planning Strategy*

In 1996, Turquoise Corporation acquired land for investment purposes at a cost of $500,000. In November 2010, Turquoise is negotiating to sell the land to Aqua Corporation for $800,000. Aqua insists that the transaction be completed in 2010, but Turquoise wants to delay the sale until 2011, to defer the tax on the gain. In an effort to compromise, Turquoise agrees to sell the land in November 2010 and asks Aqua to pay for the land in two installments, $400,000 in December 2010 and $400,000 in January 2011. This enables Turquoise to use the installment method, under which Turquoise will report $150,000 of the gain in 2010 and the remaining $150,000 in 2011.

By electing the installment method, Turquoise defers the payment of tax on $150,000 of the gain for one year. Assuming that the marginal tax rate for Turquoise is 35%, this tax deferral strategy will provide $52,500 ($150,000 × 35%) to be invested or used in the business for another year. ■

★ Framework Focus: Deductions

➤ *Tax Planning Strategy*

TAX MINIMIZATION STRATEGIES RELATED TO DEDUCTIONS

➤ ***Maximize Deductible Amounts.*** A corporation that owns stock in another corporation is eligible for a *dividends received deduction (DRD).* The DRD is equal to a specified percentage of the dividends received. The percentage is based on the amount of stock that the investor corporation owns in the investee corporation.

- 70 percent deduction for ownership of less than 20 percent.
- 80 percent deduction for ownership of 20 percent or more but less than 80 percent.
- 100 percent deduction for ownership of 80 percent or more.

Falcon Corporation invests in bonds of Sparrow Corporation and receives interest of $20,000. Red Hawk Corporation acquires 15% of the stock of Pheasant Corporation and receives a $20,000 dividend. Falcon's taxable income is increased by $20,000 of interest received. Red Hawk's income is increased by $20,000 in dividend income, but it is allowed a $14,000 dividends received deduction, thus increasing taxable income by only $6,000. ■

Example 21 demonstrates the *tax* advantage of dividend income versus interest income. However, it is also important to consider *nontax* factors. Is the investment in bonds safer than the investment in stock? Does the potential growth in the value of stock outweigh the possible risk of investing in stock versus bonds?

➤ *Tax Planning Strategy*

➤ ***Accelerate Recognition of Deductions to Achieve Tax Deferral.*** Both corporate and noncorporate taxpayers may deduct charitable contributions if the recipient is a qualified charitable organization. Generally, a deduction is allowed only for the year in which the payment is made. However, an important exception is available for *accrual basis corporations.* They may claim the deduction in the year *preceding* payment if two requirements are met. First, the contribution must be authorized by the board of directors by the end of that year. Second, the contribution must be paid on or before the fifteenth day of the third month of the next year.

Blue, Inc., a calendar year, accrual basis corporation, wants to make a $10,000 donation to the Atlanta Symphony Association (a qualified charitable organization), but does not have adequate funds to make the contribution in 2010. On December 28, 2010, Blue's board of directors *authorizes* a $10,000 contribution to the Association. The donation is made on March 14, 2011. Because Blue is an accrual basis corporation, it may claim the $10,000 donation as a deduction for tax year 2010, even though payment is not made until 2011.

Blue was able to take advantage of a tax provision and reduce 2010 taxable income by $10,000. Assuming that Blue is in the 35% marginal bracket, the corporation has been able to defer payment of $3,500 in Federal income tax. The $3,500 can be invested or used in the business for another tax year. ■

TAX MINIMIZATION STRATEGIES RELATED TO TAX RATES

★ Framework Focus: Tax Rates

➤ *Tax Planning Strategy*

➤ ***Shift Net Income from High-Bracket Years to Low-Bracket Years.*** One objective of shifting income is to defer the payment of income tax (refer to Example 20). A second time-shifting strategy is to shift *net* income from high-tax to low-tax years. This can be accomplished by shifting income from high-bracket years to low-bracket years or by shifting deductions from low-bracket years to high-bracket years.

EXAMPLE 21

Egret Corporation, a calendar year taxpayer, is in the 34% bracket in 2010, but expects to be in the 25% bracket in 2011. The corporation, which is negotiating a $10,000 service contract with a client, decides to wait until 2011 to sign the contract and perform the services. The client is indifferent as to when the contract is completed. Thus, Egret saves $900 in income tax by deferring the service contract income to 2011, when it will be taxed at the 25% rate instead of the current 34% rate.

In this case, the income-shifting strategy is used to accomplish two tax planning objectives. First, shifting the income defers the payment of income tax from 2010 to 2011. Second, the shifting strategy results in the income being taxed at a rate of 25% rather than 34%. ■

EXAMPLE 22

Macaw Corporation has been sued for $125,000 damages by a customer, and the parties decided to settle out of court for $100,000. Macaw expects to be in the 25% bracket in 2010 and the 35% bracket in 2011. Macaw will save $10,000 in income tax if it finalizes the agreement in January 2011 rather than December 2010 [$100,000 × (35% − 25%)]. ■

➤ *Tax Planning Strategy*

➤ ***Shift Net Income from High-Bracket Taxpayers to Low-Bracket Taxpayers.*** Individual income tax rates range from 10 to 35 percent. Although several provisions in the tax law prevent shifting income from high-bracket taxpayers to low-bracket taxpayers, many opportunities to do so remain. Business entities can be effective vehicles for shifting income to low-bracket taxpayers.

EXAMPLE 23

Bill Gregory is the president and sole shareholder of Grayhawk, Inc., an S corporation. He projects that Grayhawk will earn $400,000 in 2010. Bill will be taxed on this income at a 35% marginal rate. Bill and his wife have four teenage children, all of whom are dependents. Bill employs the children as part-time workers throughout the year and pays them $11,000 each. This reduces Bill's income from Grayhawk by $44,000 and reduces his Federal income tax by $15,400 ($44,000 × 35%).

Each child reports taxable income of $5,300 ($11,000 − $5,700 standard deduction) and pays $530 of Federal income tax ($5,300 × 10% rate). As a result of this income-shifting strategy, the family unit saves $13,280 ($15,400 tax saved by Bill − $2,120 tax paid by children). ■

➤ *Tax Planning Strategy*

➤ ***Shift Net Income from High-Tax Jurisdictions to Low-Tax Jurisdictions.*** A choice of the state or country where income is earned (or where a deduction is incurred) can have a large effect on an entity's overall tax liability. Hence, shifting income from high-tax jurisdictions to low-tax jurisdictions or shifting deductions from low-tax jurisdictions to high-tax jurisdictions is an important tax planning strategy.

EXAMPLE 24

Gold International owns a sales subsidiary in Texas and a manufacturing subsidiary in Ireland (which imposes a 15% tax rate on certain types of business income). The Irish subsidiary makes drill presses and sells them for $4 million to the Texas subsidiary, which then modifies them and offers them for sale to businesses in the United States for $8.4 million. The cost of manufacturing and modifying each drill press is $3 million.

Of the $5.4 million of profit earned, $1 million is attributable to the Irish corporation (which is subject to a 15% tax rate), and $4.4 million is attributable to the U.S. corporation (which is subject to a 34% tax rate). Gold's total tax liability is $1,646,000 [($1,000,000 × 15%) + ($4,400,000 × 34%)]. ■

EXAMPLE 27

Assume the same facts as in the previous example, except $5 million of the profit is attributable to the Irish corporation and $400,000 is attributable to the U.S. corporation. In this case, Gold's total tax liability is $886,000 [($5,000,000 × 15%) + ($400,000 × 34%)]. Thus, by altering the amount of work done in each of the two subsidiaries and the amount of income generated by each, Gold's tax liability is decreased by $760,000 ($1,646,000 − $886,000). ■

➤ *Tax Planning Strategy*

➤***Control the Character of Income and Deductions.*** For various policy reasons, Congress has chosen to treat certain categories of income and losses more favorably than others. For instance, the provisions that tax long-term capital gains at a maximum rate of 15 percent, compared to a top 35 percent rate on ordinary income, were enacted to encourage individuals to make long-term investments of capital in the economy.

EXAMPLE 28

Lisa is the proprietor of Designer Enterprises. Because a proprietorship is a flow-through entity, Lisa must report all of Designer's transactions on her individual income tax return. On October 9, 2009, Lisa invested $25,000 of Designer's excess cash in Lavender Corporation stock. On October 1, 2010, the stock was worth $35,000.

Lisa, who is a 35% bracket taxpayer, has decided to sell the stock and use the cash to increase Designer's inventory. She must hold the stock until October 10, 2010, for the gain to qualify as long term (held more than a year). If she sells the stock before October 10, 2010, the gain will be taxed as short term, and she will pay 35% tax on the gain. If she sells the stock after October 9, 2010, the gain is long term, and she will pay 15% tax on the gain. ■

To encourage investment in small businesses, Congress enacted the § 1244 provisions, which provide favorable Federal income tax treatment of losses incurred on the sale of qualifying small business stock. Generally, losses on the sale of stock are treated as capital losses. Individuals with capital losses in excess of capital gains are permitted to deduct only $3,000 of such losses against ordinary income in a tax year. To make small business stock more attractive as an investment, § 1244 allows up to $50,000 ($100,000 if married filing jointly) of losses on such stock to be treated as ordinary losses, thus exempting the § 1244 losses from being offset against capital gains and then from the $3,000 limit that would otherwise apply to any excess capital losses.

EXAMPLE 29

Roberto invested $80,000 in Mauve Corporation stock. He sold the stock this year for $40,000. He has no other capital asset transactions and does not expect to have any in future years. If the Mauve stock qualifies as § 1244 stock, Roberto may deduct the entire $40,000 as an ordinary loss. If the stock does not qualify as § 1244 stock, Roberto may deduct only $3,000 as a capital loss in the current tax year. He carries the remaining loss of $37,000 forward. In future years, the loss will continue to be subject to the annual $3,000 limitation unless there are offsetting capital gains. ■

➤ *Tax Planning Strategy*

➤***Avoid Double Taxation.*** The owners of a corporation can choose between two entity forms. A C corporation, also referred to as a regular corporation, is a taxable entity that pays tax on corporate profits. Shareholders also pay tax on dividends received from a C corporation, resulting in what is commonly referred to as *double taxation* (refer to Example 16). Note, however, as discussed in Chapter 4, the dividends may be eligible for a beneficial tax rate.

Shareholders can avoid double taxation by electing that a corporate entity become an S corporation. Unlike a C corporation, an S corporation is not a taxable entity. Instead, the profits and losses of the S corporation flow through to the shareholders and are reported on their tax returns (see Chapter 12).

EXAMPLE 30

Chickadee, Inc., a C corporation with net income of $100,000, pays Carl, its sole shareholder, a $77,750 dividend. Chickadee must pay corporate income tax of $22,250

on the net income of $100,000, and Carl must pay tax on the $77,750 dividend. Sparrow, Inc., an S corporation, also earns $100,000. Sparrow is not a taxable entity, so it pays no income tax on the $100,000 net income. Sam, who is the sole shareholder of Sparrow, includes $100,000 in computing his taxable income. ■

There are other entity choices that can be used to avoid double taxation, including partnerships and limited liability companies. Partnerships and limited liability companies, like S corporations, are flow-through entities rather than taxable entities (see Chapter 11).

Choosing to operate as a **flow-through entity** is not the only way to avoid double taxation. Double taxation can be avoided or minimized by having the corporation make payments, such as salaries, rent, and interest to the shareholders.

EXAMPLE 31

Walt is the president and sole shareholder of Meadowlark, Inc., a C corporation. Meadowlark's taxable income before any payment to Walt is $600,000. Walt, a skilled manager, is primarily responsible for the profitability of the corporation. If Meadowlark pays Walt a dividend of $400,000, the corporation must pay Federal income tax on $600,000, and Walt must include the $400,000 dividend in gross income. However, if Meadowlark pays Walt a salary of $400,000, the salary is deductible, and the corporation has only $200,000 of taxable income. Walt must include the $400,000 salary in gross income.

In either case, Walt includes $400,000 in gross income (the dividends may be eligible for a beneficial tax rate). Meadowlark, on the other hand, reports $400,000 less taxable income if the payment to Walt is a salary payment rather than a dividend payment. ■

TAX MINIMIZATION STRATEGIES RELATED TO CREDITS

★ Framework Focus: Credits

➤ *Tax Planning Strategy*

➤ ***Maximize Tax Credits.*** Congress uses the tax credit provisions of the Internal Revenue Code liberally in implementing tax policy. It is important to understand the difference between a credit and a deduction, both of which reduce a taxpayer's tax liability. A deduction reduces taxable income, which results in a reduction of the tax paid. The tax benefit of the deduction depends on the amount of the qualifying expenditure and the taxpayer's tax rate. A tax credit reduces the tax liability dollar for dollar and is not affected by the taxpayer's tax rate.

EXAMPLE 32

Oriole Corporation, which is in the 25% marginal bracket, has a $6,000 deduction for expenditures made to repair a machine. The deduction reduces taxable income by $6,000 and results in a tax liability reduction of $1,500 ($6,000 deduction × 25% marginal rate). Oriole also incurred expenditures of $6,000 to rehabilitate a building, which qualifies the corporation for a tax credit of $600 ($6,000 rehabilitation expenditures × 10% rate for the credit). The rehabilitation expenditures credit results in a $600 reduction of Oriole's tax liability. In addition, Oriole's depreciable basis for the building increases by $5,400 ($6,000 expenditures − $600 credit). ■

One example of the use of credits to influence taxpayer behavior is the work opportunity tax credit, which was enacted to encourage employers to hire employees from several targeted and economically disadvantaged groups, including high-risk youths, summer youth employees, and military veterans. The employee is certified to be a member of a qualifying targeted group. The work opportunity tax credit is 40 percent of the first $6,000 of wages paid during the first 12 months of employment. For long-term family assistance recipients, the credit is even greater.

EXAMPLE 33

Robin Corporation hired a high-risk youth for four months at a cost of $6,000. Robin qualifies for the work opportunity tax credit and is allowed a credit of $2,400 ($6,000 wages × 40% credit rate) and a wage deduction of $3,600 ($6,000 wages − $2,400 credit). Robin is a 34% bracket taxpayer. The $3,600 deduction reduces Robin's income tax by $1,224 ($3,600 × 34%). The total tax saving thus is $3,624 ($1,224 + $2,400 credit).

If the employee does not qualify Robin for the work opportunity tax credit, Robin is allowed a deduction of $6,000, which results in a tax saving of $2,040 ($6,000 × 34%). Thus, hiring an employee who qualifies Robin for the work opportunity tax credit will save an additional $1,584 in tax ($3,624 − $2,040). ■

THINKING OUTSIDE THE FRAMEWORK

Although the General Framework for Income Tax Planning in Figure 1.3 is broad and covers most tax planning strategies, some strategies fall outside the framework. In addition, other planning ideas can supplement the strategies in the framework. Some of these ideas are discussed below.

Determining the Tax Burden

To engage in effective tax planning, one must be able to identify the relevant tax rate that will be applied to a transaction. There are three kinds of tax rates. A taxpayer's *marginal* tax rate is paid on an additional dollar of taxable income. Referring to the corporate income tax rate schedule on the inside front cover of this text, a C corporation's marginal tax rate on its first dollar of income is 15 percent. Similarly, the marginal tax rate faced by a corporation with $100,001 of income is 39 percent.

The *average* tax rate is the ratio of taxes paid to the tax base. Thus, a corporation with $100,000 of taxable income is subject to an average tax rate of 22.25 percent ($22,250 in tax divided by $100,000 in taxable income).

A third kind of tax rate, the *effective* tax rate, can be seen as either (1) the ratio of taxes paid to financial net income before tax or (2) the sum of currently payable and deferred tax expense divided by the book net income before tax. Of these approaches to determining a taxpayer's tax rate, the marginal tax rate is most appropriate for tax planning purposes.

EXAMPLE 1.9

Azure Corporation reports taxable income of $80,000. Azure also received $10,000 of tax-free interest income from municipal bonds. Using the corporate tax rate schedule on the inside front cover of this text, one can determine that the company's tax liability is $15,450. If Azure were to earn an additional dollar in taxable income, it would pay an extra $0.34 in tax. Thus, the company's marginal tax rate is 34%. Azure's average tax rate is the ratio of taxes paid to book income or 19.3% ($15,450/$80,000). Finally, the company has an effective rate of tax of 17.2% ($15,450/$90,000), the ratio of taxes paid to book net income before tax (here, the sum of taxable income and tax-free income). ■

The actual tax paid may not always be apparent. For example, the amount of taxes paid should include both current taxes and the present value of future taxes generated by a transaction.

EXAMPLE 1.10

Magenta Corporation is a publishing company that specializes in electronic media. It is a new corporation that was formed on January 1, 2008. During that year, it generated a net operating loss (NOL) of $300,000. The NOL can be carried forward to offset future years' taxable income and thereby reduce Magenta's future tax liabilities. Magenta expects to earn $100,000 of income each year over the next four years. The NOL should completely offset the company's taxable income for the first three of these years.

At the beginning of 2009, Magenta must decide whether to invest in a project that will earn an additional $40,000 of taxable income during 2009, or in a project that will generate $36,000 of tax-free income. The company's president reasons that, since the company has an NOL carryforward, the applicable tax rate is 0%, so the taxable project should be chosen.

The president's reasoning is incorrect, because an additional $40,000 of income now will result in $40,000 of taxable income in 2011 (since there will be $40,000 less NOL available in that year).

	2009	2010	2011	2012
Alternative 1 (tax-free investment)				
Pre-NOL taxable income	$ 100,000	$ 100,000	$ 100,000	$100,000
NOL carryforward (from 2008)	(300,000)	(200,000)	(100,000)	–0–
Taxable income	$ –0–	$ –0–	$ –0–	$100,000
Alternative 2 (taxable investment)				
Pre-NOL taxable income	$ 140,000	$ 100,000	$ 100,000	$100,000
NOL carryforward (from 2008)	(300,000)	(160,000)	(60,000)	–0–
Taxable income	$ –0–	$ –0–	$ 40,000	$100,000

The tax cost of the $40,000 project equals the discounted value of the tax due for 2011. Assuming a 10% discount rate and a 15% corporate tax rate, the present value of taxes deferred for three years is $4,508, and the discounted tax rate is 11.27%. Thus, the after-tax proceeds on the taxable project are $35,492, or $508 *less* than the $36,000 earnings on the tax-free project. ■

Finally, the amount of tax paid includes both *explicit* taxes (paid directly to the government) and *implicit taxes* (paid through higher prices or lower returns on tax-favored investments).

Sunflower, Inc., a C corporation with a 15% marginal tax rate, has accumulated excess cash of $100,000 that it wants to invest in bonds. Sunflower has the option of investing in taxable corporate bonds that yield 9% or tax-free municipal bonds that yield 6%. Assume that the bonds are identical, except for their tax status.

Sunflower's tax rate on the corporate bonds is explicit at 15%. The tax rate on the municipal bonds is implicit, evidenced by the lower return on the bonds. Since the bonds are identical, if the municipal bonds were taxable, they would yield a 9% pre-tax rate. Their after-tax rate is 6% because they are tax-free. Hence, the implicit tax rate on the municipal bonds equals 33%, or the tax rate that would generate a 6% after-tax return on a 9% bond [9% − (0.33 × 9%)].

Since Sunflower is in the 15% tax bracket, it should invest in the taxable bonds, because it would face a higher marginal tax rate (a 33% implicit rate) if it invested in the municipal bonds. Stated another way, Sunflower's after-tax return on the taxable bonds is greater than the 6% return available on the tax-free bonds. ■

1.5 Understanding the Federal Tax Law

LO.6

Recognize the economic, social, equity, and political considerations that underlie the tax law.

The Federal tax law is a mosaic of statutory laws, administrative pronouncements, and court decisions. Anyone who has attempted to work with these provisions would admit to their complexity. For the person who has to trudge through a mass of rules to find the solution to a tax problem, it may be of some consolation to know that the law's complexity generally can be explained. Whether sound or not, there are reasons for the formulation of every rule. Recognizing these reasons, therefore, is an important step toward understanding the Federal tax law.

REVENUE NEEDS

The foundation of the income tax system is the raising of revenue to cover the cost of government operations. Ideally, annual outlays should not exceed anticipated revenues, thereby leading to a balanced budget with no resulting deficit. Many states have achieved this objective by passing laws or constitutional amendments precluding deficit spending.

The U.S. Constitution allows deficit spending, and politicians often find it hard to resist the temptation to spend more than the tax system collects currently. Congress

uses several approaches to reduce a tax bill's net revenue loss. When tax reductions are involved, the full impact of the legislation can be phased in over a period of years. Or, as an alternative, the tax reduction can be limited to a period of years. When the period expires, Congress can then renew or not renew the provision in light of budget considerations.

ECONOMIC CONSIDERATIONS

Using the tax system in an effort to accomplish economic objectives has become increasingly popular in recent years. Generally, proponents of this approach use tax legislation to promote measures designed to help control the economy or encourage certain economic activities and businesses.

Encouragement of Certain Activities

Without passing judgment on the wisdom of any such choices, it is quite clear that the tax law does encourage certain types of economic activity or segments of the economy. For example, the favorable treatment (immediate deduction) allowed research and development expenditures can be explained by the desire to foster technological progress.

Similarly, Congress has used depreciation deductions as a means of encouraging investment in business capital. Theoretically, shorter asset lives and accelerated methods should encourage additional investment in depreciable property acquired for business use. Conversely, longer asset lives and the required use of the straight-line method of depreciation dampen the tax incentive for capital outlays.

Part of the tax law addresses the energy crisis—in terms of both our reliance on foreign oil and the need to ease the problem of global warming. For example, tax credits are available to those who purchase motor vehicles that operate on alternative (i.e., nonfossil) fuels. Residential energy credits are allowed for home improvements that conserve energy or make its use more efficient (e.g., solar hot water, geothermal heat pumps). Ecological considerations justify a tax provision that permits a more rapid expensing of the costs of installing pollution control facilities. Measures such as these that aid in maintaining a clean air environment and conserving energy resources can also be justified under social considerations.

Is it wise to stimulate U.S. exports of goods and services? Considering the pressing and continuing problem of a deficit in the U.S. balance of payments, the answer should be clear. In an international setting, Congress has deemed it advisable to establish incentives for U.S. citizens who accept employment overseas.

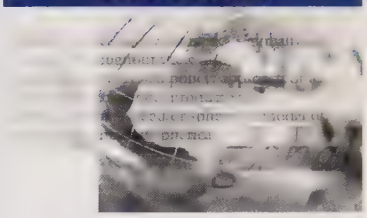
Is saving desirable for the economy? Saving leads to capital formation and thereby makes funds available to finance home construction and industrial expansion. The tax law encourages saving by according preferential treatment to private retirement plans. Not only are deductions allowed for contributions to certain retirement plans and Individual Retirement Accounts (IRAs), but income on the contributions is not taxed until withdrawn.

Encouragement of Certain Industries

A sound agricultural base is necessary for a well-balanced national economy. Undoubtedly, this explains why farmers are accorded special treatment under the Federal income tax system. Among the benefits available to farmers are the election to expense rather than capitalize certain soil and water conservation expenditures and fertilizers and the election to defer the recognition of gain on the receipt of crop insurance proceeds.

To stimulate the manufacturing industry, Congress enacted the domestic production activities deduction. The provision creates a tax benefit in the form of a deduction for profits derived from manufacturing activities conducted within the United States. By restricting the deduction to manufacturing income attributable to wages

GLOBAL *Tax Issues*



Outsourcing of Tax Return Preparation

The use of foreign nationals to carry out certain job assignments for U.S. businesses is an increasingly popular practice. Outsourcing such activities as telemarketing to India, for example, usually produces the same satisfactory result but at a much lower cost.

Outsourcing is now also being applied to the preparation of tax returns. Not only can this practice be expected to continue, but it probably will increase in volume. Outsourcing tax return preparation does not violate Federal law, and the practice is compatible with accounting ethical guidelines as long as three safeguards are followed: First, the practitioner must make sure that client confidentiality is maintained. Second, the practitioner must verify the accuracy of the work that has been outsourced. Third, the practitioner must inform clients, preferably in writing, when any third-party contractor is used to provide professional services.

Practitioners justify the outsourcing practice as a means of conserving time and effort that can be applied toward more meaningful tax planning on behalf of their clients.

reportable to the IRS, new U.S. jobs will result, and the outsourcing of labor is discouraged. Thus, the tax system is used to encourage both domestic manufacturing and job growth.

Encouragement of Small Business

It seems that in the United States, a consensus exists that what is good for small business is good for the economy as a whole. This assumption has led to a definite bias in the tax law favoring small business. Several income tax provisions can be explained by the desire to benefit small business, including the low marginal tax rates applied to the first dollars of the entity's income.

SOCIAL CONSIDERATIONS

Some provisions of the Federal tax law, particularly those dealing with the income tax of individuals, can be explained by a desire to encourage certain social results.

- Certain benefits provided to employees through accident and health insurance plans financed by employers are nontaxable to employees. Encouraging such plans is considered socially desirable since they provide medical benefits in the event of an employee's illness or injury.
- A contribution made by an employer to a qualified pension or profit sharing plan for an employee may receive special treatment. The contribution and any income it generates are not taxed to the employee until the funds are distributed. Such an arrangement also benefits the employer by allowing a tax deduction when the contribution is made to the qualified plan. Various types of retirement plans are encouraged to supplement the subsistence income level the employee otherwise would obtain under the Social Security system.
- A deduction is allowed for contributions to qualified charitable organizations. The deduction attempts to shift some of the financial and administrative burden of socially desirable programs from the public (government) to the private (citizens) sector.
- Various tax credits, deductions, and exclusions are designed to encourage taxpayers to obtain or extend the level of education.
- A tax credit is allowed for amounts spent to furnish care for certain minor or disabled dependents to enable the taxpayer to seek or maintain gainful employment.

A tax deduction is denied for certain expenditures deemed to be contrary to public policy. This disallowance extends to such items as fines, penalties, illegal kickbacks, bribes to government officials, and gambling losses in excess of gains. Social considerations dictate that the tax law should not encourage these activities by permitting a deduction.

EQUITY CONSIDERATIONS

The concept of equity is relative. Reasonable persons can, and often do, disagree about what is fair or unfair. In the tax area, moreover, equity is most often tied to a particular taxpayer's personal situation. To illustrate, compare the tax positions of those who rent their personal residences with those who own their homes. Renters may not take a Federal income tax deduction for the rent they pay. For homeowners, however, a large portion of the house payments they make may qualify for the Federal mortgage interest and property tax deductions. Although renters may have difficulty understanding this difference in tax treatment, the encouragement of home ownership can be justified on both economic and social grounds.

In many other parts of the law, however, equity concerns are evident. The concept of equity appears in tax provisions that alleviate the effect of multiple taxation and postpone the recognition of gain when the taxpayer lacks the ability or **wherewithal to pay** the tax. Provisions that mitigate the effect of the application of the annual accounting period concept and help taxpayers cope with the eroding results of inflation also reflect equity considerations.

Alleviating the Effect of Multiple Taxation

The income earned by a taxpayer may be subject to taxes imposed by different taxing authorities. If, for example, the taxpayer is a resident of New York City, income might be subject to Federal, state of New York, and city of New York income taxes. To compensate for this apparent inequity, the Federal tax law allows a taxpayer to claim a deduction for state and local income taxes.

The deduction does not, however, neutralize the effect of multiple taxation, since the benefit derived depends on the taxpayer's Federal income tax rate. Only a tax credit, rather than a deduction, would completely eliminate the effects of multiple taxation on the same income. Equity considerations also can explain the Federal tax treatment of certain income from non-U.S. sources.

The Wherewithal to Pay Concept

The wherewithal to pay concept recognizes the inequity of taxing a transaction when the taxpayer lacks the means to pay the tax. The wherewithal to pay concept underlies a provision in the tax law dealing with the treatment of gain resulting from an involuntary conversion. An involuntary conversion occurs when property is destroyed by casualty or taken by a public authority through condemnation. If gain results from the conversion, it need not be recognized if the taxpayer replaces the property within a specified time period. The replacement property must be similar or related in service or use to that involuntarily converted.

EXAMPLE 10

Ron, a rancher, has some pasture land that is condemned by the state for use as a game preserve. The condemned pasture land cost Ron $120,000, but the state pays him $150,000 (its fair market value). Shortly thereafter, Ron buys more pasture land for $150,000.

Ron has a realized gain of $30,000 [$150,000 (condemnation award) − $120,000 (cost of land)]. It would be inequitable to require Ron to pay a tax on this gain for two reasons. First, without disposing of the property acquired (the new land), Ron would be hard-pressed to pay the tax. Second, his economic position has not changed. ■

Assume the same facts as in Example 37, except that Ron reinvests only $140,000 of the award in new pasture land. Now, Ron has a taxable gain of $10,000. Instead of ending up with only replacement property, Ron now holds land *and* $10,000 in cash. ■

Mitigating the Effect of the Annual Accounting Period Concept

For purposes of effective administration of the tax law, all taxpayers must report to and settle with the Federal government at periodic intervals. Otherwise, taxpayers would remain uncertain as to their tax liabilities, and the government would have difficulty judging revenues and budgeting expenditures. The period selected for final settlement of most tax liabilities is one year.

The application of this annual accounting period concept can lead to dissimilar tax treatment for taxpayers who are, from a long-range standpoint, in the same economic position.

José and Alicia, both sole proprietors, experienced the following results during the indicated three tax years.

	Profit (or Loss)	
Year	José	Alicia
2010	$50,000	$150,000
2011	60,000	60,000
2012	60,000	(40,000)

Although José and Alicia have the same profit of $170,000 over the period from 2010 through 2012, the annual accounting period concept places Alicia at a disadvantage for tax purposes. However, the net operating loss deduction generated in 2012 offers Alicia some relief by allowing her to carry back some or all of her 2012 loss to the earlier profitable years (in this case, 2010). Thus, with an NOL carryback, Alicia can obtain an immediate refund for some of the taxes she paid on the $150,000 profit reported for 2010. ■

The installment method of recognizing gain on the sale of property allows a taxpayer to spread tax consequences over the payout period. The harsh effect of taxing all the gain in the year of sale thereby is avoided. The installment method also can be explained by the wherewithal to pay concept, since recognition of gain is tied to the collection of the installment notes received from the sale of the property.

Coping with Inflation

Because of the progressive nature of the income tax, a wage adjustment to compensate for inflation can push the recipient into a higher income tax bracket without increasing real income. Known as *bracket creep*, this phenomenon's overall impact is an erosion of purchasing power. Congress recognized this problem and began to adjust various income tax components, such as marginal tax brackets, standard deduction amounts, and personal and dependency exemptions. Indexation usually is based upon the rise in the consumer price index over the prior year.

POLITICAL CONSIDERATIONS

A large segment of the Federal tax law is made up of statutory provisions. Since these statutes are enacted by Congress, is it any surprise that political considerations influence tax law?

Special Interest Legislation

There is no doubt that certain provisions of the tax law can largely be explained by the political influence some groups have had on Congress. For example, is there any

other realistic reason that prepaid subscription and dues income is not taxed until earned, while prepaid rents are taxed to the landlord in the year received?

One 2004 statutory provision, sponsored by Senator Zell Miller (D–Ga.), suspended the import duties on ceiling fans. The nation's largest seller of ceiling fans is Home Depot, which is based in Atlanta, Georgia. Another 2004 provision, sponsored by then House Speaker Dennis Hastert (R–Ill.), reduced the excise taxes on fishing tackle boxes. Representative Hastert's district includes Plano Molding, a major manufacturer of tackle boxes. The justification for this change was that it placed tackle boxes on a more level playing field with toolboxes (which are not subject to tax). Allegedly, fishermen had been buying and converting toolboxes to avoid the excise tax!

Special interest legislation is not necessarily to be condemned if it can be justified on economic, social, or some other utilitarian grounds. In most cases, however, it is objectionable in that it adds further complexity to an already cluttered tax law. At any rate, it is an inevitable product of our political system.

Political Expediency

Various tax reform proposals rise and fall in favor with the shifting moods of the American public. That Congress is sensitive to popular feeling is an accepted fact. Therefore, certain provisions of the tax law can be explained by the political climate at the time they were enacted.

Measures that deter more affluent taxpayers from obtaining so-called preferential tax treatment always have had popular appeal and, consequently, the support of Congress. Provisions such as the limitation on the deductibility of interest on investment indebtedness can be explained on this basis.

State and Local Government Influences

State law has had an influence in shaping our present Federal tax law. One example of this effect is the evolution of Federal tax law in response to states with community property systems. The states with community property systems are Louisiana, Texas, New Mexico, Arizona, California, Washington, Idaho, Nevada, and Wisconsin. Spouses in Alaska can elect community property treatment. The rest of the states are common law jurisdictions. The difference between common law and community property systems centers around the property rights possessed by married persons. In a common law system, each spouse owns whatever he or she earns. Under a community property system, one-half of the earnings of each spouse is considered owned by the other spouse.

EXAMPLE 40

Al and Fran are husband and wife, and their only income is the $80,000 annual salary Al receives. If they live in New Jersey (a common law state), the $80,000 salary belongs to Al. If, however, they live in Arizona (a community property state), the $80,000 is divided equally, in terms of ownership, between Al and Fran. ■

At one time, the tax position of the residents of community property states was so advantageous that many common law states adopted community property systems. Needless to say, the political pressure placed on Congress to correct the disparity in tax treatment was considerable. To a large extent, this was accomplished in 1948 when the law extended many of the community property tax advantages to residents of common law jurisdictions.

The major advantage extended was the provision allowing married taxpayers to file joint returns and compute the tax liability as if the income had been earned one-half by each spouse. This result is automatic in a community property state, since half of the income earned by one spouse belongs to the other spouse. The income-splitting benefits of a joint return are incorporated as part of the tax rates applicable to married taxpayers. A similar motivation can be seen for the gift-splitting provisions of the Federal gift tax and the marital deduction of the Federal estate and gift taxes.



BRIDGE TO POLITICAL SCIENCE AND SOCIOLOGY

The country's wrestling with the issue of same-sex marriage has important tax ramifications. One recent study noted that, if all committed same-sex couples were to be legally married under state laws (perhaps 400,000 now-single filers), any income tax revenue increase would be offset many times over by the additional Social Security and Medicare claims from one member of the couple against the other's accounts.

But this issue is still working its way through the statehouses and courthouses. For instance, how should someone file a tax return given the current developments?

- Same-sex marriage is allowed in only a few cities, states, and counties. On a Federal income tax return, what is the correct filing status for those with some form of a marriage certificate?
- Are we certain that the various forms of civil unions and other contractual arrangements allowed by dozens of localities do not qualify the parties for married status on a Federal income tax return? This is a court case waiting to happen. Federal law passed under President Clinton (the Defense of Marriage Act of 1996) makes it clear that a "marriage" consists of one male and one female. The IRS follows all Federal laws, but what about the couple's state and local income tax returns? Can an individual file as single on one tax return and married on another for the same tax year? And how would tax software handle this?

Same-sex advocates say that "Federal tax law requires us to perjure ourselves" in that same-sex couples who see themselves as married must file as single on the Form 1040. They compare the situation to the "don't ask, don't tell" culture of the military. Will the Federal government require jail time for those who file knowingly inaccurate/fraudulent tax returns? Some have concluded that the proper filing status in this situation is Married – Separate, but that would subject the individual to the highest of the Form 1040 tax rate schedules.

State-Federal law conflicts have affected citizens at other times in U.S. history.

- A few states allowed voting by women before the U.S. Constitution adopted the rule.
- "Nevada divorces" were not recognized by the home states of all couples. As recently as 1940, charges of bigamy were brought against those with Nevada divorces who remarried outside Nevada.
- A few states now recognize same-sex marriages performed in other jurisdictions, including those performed outside the United States.

Who would have thought that the important tax question "Are you married?" could become so difficult to answer?

INFLUENCE OF THE INTERNAL REVENUE SERVICE

LO.7

Describe the role played by the IRS and the courts in the evolution of the Federal tax system.

The influence of the IRS on tax law is apparent in many areas beyond its role in issuing the administrative pronouncements that make up a considerable portion of our tax law. The IRS has been instrumental in securing the passage of much legislation designed to curtail the most flagrant tax avoidance practices (to "close tax loopholes"). In addition, the IRS has sought and obtained legislation to make its own job easier (to attain administrative feasibility).

Closing Perceived Tax Loopholes

Certain tax provisions are intended to prevent a loophole from being used to avoid the tax consequences intended by Congress. Working within the letter of existing law, taxpayers and their advisers devise techniques that accomplish indirectly what cannot be accomplished directly. As a consequence, legislation is enacted to close the loopholes that taxpayers have located and exploited. Some tax law can be explained in this fashion and is discussed in the chapters to follow.

Administrative Feasibility

Some tax law is justified on the grounds that it simplifies the task of the IRS in collecting the revenue and administering the law. With regard to collecting the revenue, the IRS long ago realized the importance of placing taxpayers on a pay-as-you-go

TAX IN THE NEWS: THE COSTS OF COMPLEXITY

A tax system that is designed to accomplish so many, sometimes contradictory, goals is bound to be a complex animal. According to the Tax Foundation, the current system may actually be so complex as to be self-defeating. By one measure, the costs of complying with the individual income tax portions of the Internal Revenue Code—taxpayers' time, record-keeping systems and software, and costs for tax advisers and preparers—equal 22.2 cents for every dollar collected by the Treasury for the tax year.

basis. Elaborate withholding procedures apply to wages, and accrual basis taxpayers often must pay taxes on prepaid income in the year received and not when earned. The approach may be contrary to generally accepted accounting principles, but it is consistent with the wherewithal to pay concept.

Of considerable aid to the IRS in collecting revenue are the numerous provisions that impose interest and penalties on taxpayers for noncompliance with the tax law. Provisions such as the penalties for failure to pay a tax or to file a return that is due, the negligence penalty for intentional disregard of Federal tax rules and regulations, and various penalties for civil and criminal fraud serve as deterrents to taxpayer noncompliance.

One of the keys to an effective administration of our tax system is the audit process conducted by the IRS. To carry out this function, the IRS is aided by provisions that reduce the chance of taxpayer error or manipulation and therefore reduce the audit effort that is necessary. An increase in the amount of the standard deduction, for example, reduces the number of individual taxpayers who will choose the alternative of itemizing their personal deductions. With fewer deductions to check, the audit function is simplified.

DIGGING DEEPER 4

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

INFLUENCE OF THE COURTS

In addition to interpreting statutory provisions and the administrative pronouncements issued by the IRS, the Federal courts have influenced tax law in two other respects. First, the courts have formulated certain judicial concepts that serve as guides in the application of various tax provisions. Second, certain key decisions have led to changes in the Internal Revenue Code.

Judicial Concepts Relating to Tax

Particularly in dealings between related parties, the courts test transactions by looking to whether the taxpayers acted in an arm's length manner. The question to be asked is: Would unrelated parties have handled the transaction in the same way?

EXAMPLE 9

Rex, the sole shareholder of Silver Corporation, leases property to the corporation for a yearly rent of $6,000. To test whether the corporation should be allowed a

rent deduction for this amount, the IRS and the courts will apply the arm's length concept. Would Silver Corporation have paid $6,000 a year in rent if it had leased the same property from an unrelated party (rather than from Rex)? Suppose it is determined that an unrelated third party would have paid an annual rent for the property of only $5,000. Under these circumstances, Silver Corporation will be allowed a deduction of only $5,000. The other $1,000 it paid for the use of the property represents a nondeductible dividend. Accordingly, Rex will be treated as having received rent income of $5,000 and dividend income of $1,000. ■

Judicial Influence on Statutory Provisions

Some court decisions have been of such consequence that Congress has incorporated them into statutory tax law. For example, many years ago the courts found that stock dividends distributed to the shareholders of a corporation were not taxable as income. This result largely was accepted by Congress, and a provision in the tax statutes now addresses the issue.

On occasion, however, Congress has reacted negatively to judicial interpretations of the tax law.

EXAMPLE 42

Nora leases unimproved real estate to Wade for 20 years. At a cost of $400,000, Wade erects a building on the land. The building is worth $150,000 when the lease terminates and Nora takes possession of the property. Does Nora have any gross income either when the improvements are made or when the lease terminates? In a landmark decision, a court held that Nora must recognize income of $150,000 upon the termination of the lease. ■

Congress felt that the result reached in Example 42 was inequitable in that it was not consistent with the wherewithal to pay concept. Consequently, the tax law was amended to provide that a landlord does not recognize any income either when the improvements are made (unless made in lieu of rent) or when the lease terminates.

1.6 SUMMARY

In addition to its necessary revenue-raising objective, the Federal tax law has developed in response to several other factors.

- *Economic considerations.* The emphasis here is on tax provisions that help regulate the economy and encourage certain activities and types of businesses.
- *Social considerations.* Some tax provisions are designed to encourage (or discourage) socially desirable (or undesirable) practices.
- *Equity considerations.* Of principal concern in this area are tax provisions that alleviate the effect of multiple taxation, recognize the wherewithal to pay concept, mitigate the effect of the annual accounting period concept, and recognize the eroding effect of inflation.
- *Political considerations.* Of significance in this regard are tax provisions that represent special interest legislation, reflect political expediency, and reflect the effect of state and local law.
- *Influence of the IRS.* Many tax provisions are intended to aid the IRS in the collection of revenue and the administration of the tax law.
- *Influence of the courts.* Court decisions have established a body of judicial concepts relating to tax law and have, on occasion, led Congress to enact statutory provisions to either clarify or negate their effect.

REFOCUS ON THE BIG PICTURE

MIKE AND GINA FACE REALITY

Unfortunately, Mike and Gina may have paid that much tax and more. In addition to Federal income tax of over $36,000 (an average rate of 21 percent), Mike paid self-employment tax of $14,130 ($100,000 × 92.35% × 15.3%). A deduction is allowed for one-half of the self-employment tax paid (7.65 percent), so net earnings from self-employment are multiplied by 92.35 percent in arriving at the earnings subject to the tax. Gina paid FICA tax of $7,650 ($100,000 × 7.65%). Her employer paid a matching amount of tax. Depending on where they live, they probably paid state income taxes of another $10,000 to $14,000. Add in the sales taxes, excise taxes, and property taxes that they also incurred, and a high-income couple's total taxes easily can exceed 35 percent of their income.

What If?

Mike's 90-year-old grandmother just told him that he is the sole heir of her $5 million estate. What are the tax implications if Mike's grandmother dies this year?

While Mike's grandmother may owe a substantial Federal estate tax, the tax is levied on the decedent, not the recipient of the estate assets. However, a few states levy an inheritance tax on heirs, so Mike may owe taxes to the state.

SUGGESTED READINGS

John S. Irons and Michael Powers, "Tax Complexity: By the Numbers," October 2005, **www.americanprogress.org**.

"Policymaking and the New President: Tax Priorities," November 2008, **taxpolicycenter.org**.

"What the Federal Tax System Is Costing You—Tax Compliance Facts," 2007 working paper at **www.fairtax.org**.

KEY TERMS

Ad valorem taxes, 1–11
C corporations, 1–18
Employment taxes, 1–3
Estate tax, 1–9
Excise taxes, 1–4
FICA tax, 1–8
Flow-through entity, 1–25
Franchise tax, 1–14
FUTA tax, 1–8
Gift taxes, 1–3
Inheritance tax, 1–9
Occupational taxes, 1–14
Personalty, 1–11
Proprietorship, 1–17
Realty, 1–11
S corporations, 1–18
Sales taxes, 1–3
Tax avoidance, 1–20
Tax evasion, 1–20
Use taxes, 1–7
Value added tax (VAT), 1–7
Wherewithal to pay, 1–30

PROBLEMS

ISSUE ID

1. **LO.1, 2, 5** Aqua Corporation believes that it will have a better distribution location for its product if it relocates the corporation to another state. What considerations (both tax and nontax) should Aqua Corporation weigh before making a decision on whether to make the move?

2. **LO.1, 2** Are the following taxes *proportional* or *progressive*?
   a. Social Security tax.
   b. Federal gift tax.

c. Federal excise tax on cigarettes.
d. Federal corporate income tax.

3. **LO.2** Cardinal College is considering purchasing two apartment buildings that are near the campus and converting them into student dormitories. The city where the college is located opposes the purchase. Why? **ISSUE ID**

4. **LO.1, 6** In terms of Adam Smith's canon of *certainty*, how does the Federal income tax fare? **CRITICAL THINKING**

5. **LO.2** Jim, a resident of Washington (which imposes a general sales tax), goes to Oregon (which does not impose a general sales tax) to purchase his automobile. Will Jim successfully avoid the Washington sales tax? Explain.

6. **LO.2** In 2010, Horace makes a taxable gift of $250,000 upon which he pays a Federal gift tax of $70,800. In 2011, Horace makes another taxable gift of $250,000. Will the 2011 taxable gift result in the same gift tax as the 2010 gift? Why or why not?

7. **LO.2** How much property can Herman, a widower, give to his four married children, their spouses, and eight grandchildren over a period of 10 years without making a taxable gift?

8. **LO.2** Once its new facilities are finished, the Church of the Good Samaritan moves from downtown Madison City to the suburbs. Instead of disposing of the old location, the church leases it to a former mayor of Madison City who converts the church building and its parking lot into a high-end restaurant. Comment on any tax ramifications of this arrangement. **ISSUE ID**

9. **LO.2** The Toth family lives in a residence that they have owned for several years. They purchased the residence from St. Matthew's Catholic Church, which had used the house as a rectory for its priest. To the Toths' surprise, since they purchased the residence, they have not received any ad valorem property tax bills from either the city or the county. Is there a plausible explanation for this? Explain. What, if anything, should the Toths do about the property tax matter? **ETHICS AND EQUITY**

10. **LO.2** The Adams Independent School District desires to sell a parcel of unimproved land that it does not need. Its three best offers are as follows: from State Department of Public Safety (DPS), $2.3 million; from Second Baptist Church, $2.2 million; and from Baker Motors, $2.1 million. DPS would use the property for a new state highway patrol barracks, Second Baptist would start a church school, and Baker would open a car dealership. As the financial adviser for the school district, which offer would you prefer? Why? **ISSUE ID**

11. **LO.2** Shaquille O'Neal, a perennial All-Star in the National Basketball Association, once was traded by the Los Angeles Lakers to the Miami Heat. Discuss Shaq's state income tax situation both before and after the trade. **ISSUE ID**

12. **LO.2** Due to the economic downturn, many states are encountering reduced tax revenues—particularly from property and sales taxes. Several states with large mineral resources (e.g., Alaska and oil, Wyoming and coal), however, are making up the shortfall with another type of tax. Explain.

13. **LO.2** The commissioners for Colby County are actively negotiating with Eagle Industries regarding the location of a new manufacturing facility in the county. As Eagle has several sites from which to pick, a "generous tax holiday" may be needed to influence its choice. The local school district is opposed to this targeted tax incentive.
    a. What might a proposal for a "generous tax holiday" entail?
    b. Why should the school district be opposed?

14. **LO.2** Brent is shocked when he learns that the property taxes on his personal residence have increased for 2010. Not only has the tax rate not changed, but he feels that the value of his residence has decreased. What could be a possible explanation for what has happened? **ISSUE ID**

15. **LO.2** During a social event, Muriel and Earl are discussing the home computer each recently purchased. Although the computers are identical makes and models, Muriel is surprised to learn that she paid a sales tax, while Earl did not. Comment as to why this could happen. **ISSUE ID**

ISSUE ID

16. **LO.2** Eileen, a resident of Wyoming, goes to Montana to purchase her new automobile. She does this because Wyoming imposes a sales tax while Montana does not. Has Eileen successfully avoided the Wyoming sales tax? Explain.

17. **LO.3** Jill is a single individual. Jill has total income of $220,000, credits of $19,000, exclusions of $30,000, deductions *for* AGI of $50,000, itemized deductions of $20,000 (assume no AGI limitations are applicable), a standard deduction of $5,700, a personal exemption equal to $3,650, and estimated tax payments of $12,500.
    a. What is her 2010 tax due?
    b. If Jill were a corporation instead of an individual, and if all of her deductions were business related, what would be the tax due?

DECISION MAKING

COMMUNICATIONS

18. **LO.4, 5** Cory and Cynthia have decided to go into business together. They will operate a sandwich delivery business. They expect to have a loss in the first and second years of the business and subsequently expect to make a substantial profit. Both are also concerned about potential liability if a customer ever gets sick. They have called your office and asked for advice about whether they should run their business as a partnership or as a corporation. Write a letter to Cynthia Clay, at 1206 Seventh Avenue, Fort Worth, TX 76101, describing the alternative forms of business that they can select. In your letter, explain what form or forms of business you recommend and why.

DECISION MAKING

19. **LO.4, 5** Ashley runs a small business in Boulder, Colorado, that makes snow skis. She expects the business to grow substantially over the next three years. Because she is concerned about product liability and is planning to take the company public in 2011, she is currently considering incorporating the business. Financial data are as follows.

	2010	2011	2012
Sales revenue	$150,000	$320,000	$600,000
Tax-free interest income	5,000	8,000	15,000
Deductible cash expenses	30,000	58,000	95,000
Tax depreciation	25,000	20,000	40,000

Ashley expects her marginal tax rate to be 35% over the next three years before any profits from the business are considered. Her cost of capital is 10%.
    a. Compute the present value of the future cash flows for 2010 to 2012, assuming Ashley incorporates the business and pays all after-tax income as dividends (that qualify for the 15% rate).
    b. Compute the present value of the future cash flows for 2010 to 2012, assuming Ashley continues to operate the business as a sole proprietorship.
    c. Should Ashley incorporate the business this year? Why or why not?

20. **LO.5** Sienna, Inc., faces a marginal tax rate of 25%, an average tax rate of 17.5%, and an effective marginal tax rate of 16.8%. Sienna is considering investing in Kiowa County bonds, which currently pay a 5% return (equivalent taxable bonds are paying an 8% return).
    a. What is the implicit tax rate on the Kiowa County bonds?
    b. Are the Kiowa County bonds a good investment for Sienna? Why or why not?

21. **LO.5** Chartreuse, Inc., has a net operating loss carryforward of $100,000. If Chartreuse continues its business with no changes, it will have $50,000 of taxable income (before the NOL) in both 2010 and 2011. If Chartreuse decides to invest in a new product line instead, it expects to have taxable income of $70,000 in 2010 and $50,000 in 2011. What marginal tax rate does the new product line face in 2010 and in 2011?

22. **LO.5** Mauve Supplies, Inc., reports total income of $120,000. The corporation's taxable income is $105,000. What are Mauve's marginal, average, and effective tax rates?

ISSUE ID

23. **LO.2** Franklin County is in dire financial straits and is considering a number of sources for additional revenue. Evaluate the following possibilities in terms of anticipated taxpayer compliance.
    a. A property tax on business inventories.
    b. A tax on intangibles (i.e., stocks and bonds) held as investments.
    c. A property tax on boats used for recreational purposes.

24. **LO.6** Discuss the probable justification for each of the following provisions of the tax law.
    a. The § 179 election to expense certain capital assets upon their acquisition.
    b. Favorable treatment accorded to research and development expenditures.
    c. A deduction for profits from U.S. manufacturing operations.
    d. Election to expense certain soil and water conservation and fertilizer expenditures.
    e. The deduction allowed for contributions to qualified charitable organizations.

25. **LO.6** Discuss the probable justification for each of the following provisions of the tax law.
    a. An election that allows certain corporations to avoid the corporate income tax and pass losses through to their shareholders.
    b. A tax credit for amounts spent to furnish care for minor children while the parent works.
    c. An election that allows the deferral of gain recognition on the receipt of crop insurance proceeds.
    d. The tax rates applicable to married persons who file a joint return.

26. **LO.6** Discuss the probable justification for each of the following aspects of the tax law.
    a. Prepaid income is taxed to the recipient in the year received and not in the year it is earned.
    b. A taxpayer that sells property on an installment basis can recognize gain on the sale over the period the payments are received.
    c. Every year the tax brackets and the amounts of the standard deduction and dependency exemptions are adjusted by the IRS.

27. **LO.6** In terms of tax reform policy, what do the following mean? **CRITICAL THINKING**
    a. Revenue neutrality.
    b. Pay-as-you-go or "paygo."
    c. Sunset provision.
    d. Stealth taxes.

28. **LO.2** Contrast a value added tax (VAT) with a national sales tax in terms of anticipated taxpayer compliance. **CRITICAL THINKING**

29. Go to **www.taxfoundation.org** and determine Tax Freedom Day for your state for 1950, 1960, 1970, 1980, 1990, 2000, and 2009. Report your results as a line graph. **CRITICAL THINKING** **COMMUNICATIONS**

30. Although the Federal income tax law is complex, most individual taxpayers are able to complete their tax returns without outside assistance. Gather data as to the accuracy of this statement. Summarize your comments in an e-mail to your instructor. **CRITICAL THINKING** **COMMUNICATIONS**

31. President Franklin D. Roosevelt once said, "I am wholly unable to figure out the amount of tax," and wrote to the Federal Commissioner of Revenue, "may I ask that (the agency) let me know the amount of the balance due." **ETHICS AND EQUITY**

    When a friend of FDR was ordered to pay $420,000 in tax penalties, the President called the Commissioner within earshot of reporters and told him to cut the penalties to $3,000. One listener, David Brinkley, recalled years later: "Nobody seemed to think it was news or very interesting." Evaluate the President's comments and actions.

Bridge DISCIPLINE

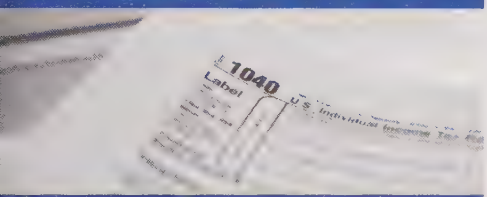
1. Discuss with respect to the Federal policy for reducing poverty.
    a. The individual income tax.
    b. The Social Security tax.

2. Prepare a two-page paper to submit to your sociology professor, titled "How I Would Apply Federal Tax Law to a Gay Married Couple." **COMMUNICATIONS**

3. Prepare an outline for a 10-minute speech to your government class. The speech is titled "If You Don't Pay Federal Taxes, You Can't Vote." **COMMUNICATIONS**

CHAPTER 2

Working with the Tax Law



LEARNING OBJECTIVES

After completing Chapter 2, you should be able to:

LO.1 Understand the statutory, administrative, and judicial **sources of the tax law** and the purpose of each source. **(pp. 2-2 to 2-18)**

LO.2 Locate and work with the tax law and understand the tax **research process**. **(pp. 2-18 to 2-25)**

LO.3 **Communicate the results** of the tax research process in a client letter and a tax file memorandum. **(pp. 2-25 to 2-26)**

LO.4 Have an awareness of **how best to use a computer** when performing tax research and in taking the **CPA exam**. **(pp. 2-26 to 2-31)**

TAX *Talk*

The less people know about how sausages and laws are made, the better they'll sleep at night.

—Otto von Bismarck

OUTLINE

2.1 Tax Sources, 2-2
Statutory Sources of the Tax Law, 2-3
Administrative Sources of the Tax Law, 2-7
Judicial Sources of the Tax Law, 2-11
2.2 Working with the Tax Law—Tax Research, 2-18
Identifying the Problem, 2-19
Refining the Problem, 2-20
Locating the Appropriate Tax Law Sources, 2-21
Assessing Tax Law Sources, 2-21
Arriving at the Solution or at Alternative Solutions, 2-25
Communicating Tax Research, 2-25
Follow-up Procedures, 2-26
Computers and Tax Research, 2-26
2.3 Tax Research on the CPA Examination, 2-29

THE BIG PICTURE Tax Solutions for the Real World

RESEARCHING TAX QUESTIONS

Richard and Sally Letterman's tax return was audited by the IRS, which found that they owed $10,000 in taxes on income that they thought could be excluded from taxable income. In assessing the additional tax (and penalties and interest), the IRS agent relied on a Revenue Ruling dealing with a similar but not identical fact situation. Richard and Sally have asked you to research the issue for them and to see if you can find support for excluding the income. After working on the issue for several hours, you identify an appellate court case that supports Richard and Sally's conclusion that the income could be excluded and says that the Revenue Ruling incorrectly applies the tax law. Can Richard and Sally rely on the court's decision? **Read the chapter and formulate your response.**

2.1 Tax Sources

LO.1
Understand the statutory, administrative, and judicial sources of the tax law and the purpose of each source.

Understanding taxation requires a mastery of the sources of the *rules of tax law.* These sources include not only legislative provisions in the form of the Internal Revenue Code, but also congressional Committee Reports, Treasury Department Regulations, other Treasury Department pronouncements, and court decisions. Thus, the *primary sources* of tax information include pronouncements from all three branches of government: legislative, executive, and judicial.

In addition to being able to locate and interpret the sources of the tax law, a tax professional must understand the relative weight of authority within these sources. The tax law is of little significance, however, until it is applied to a set of facts and circumstances. This chapter, therefore, both introduces the statutory, administrative, and judicial sources of the tax law *and* explains how the law is applied to individual and business transactions. It also explains how to apply research techniques effectively.

Tax research is necessary because the application of the law to a specific situation sometimes is not clear. As complicated as the Internal Revenue Code is, it cannot clearly address every conceivable situation. Accordingly, the tax professional must search other sources (such as administrative rulings and judicial decisions) to determine the most likely tax treatment of a transaction.

The tax research process can yield widely differing results for similar fact patterns. One of the goals of tax research is to discover which facts and which legal rules are most relevant in determining the ultimate tax consequences. Working with such knowledge, a tax professional then can advise the client about the tax consequences of several possible courses of action. Tax research, in other words, is of critical importance not only in properly characterizing completed events but also in planning proposed transactions.



SCOPE OF THE U.S. TAX SYSTEM

Although it started out in 1913 as a tax on only the uppermost-income individuals, the tax system today is pervasive in our lives.

- The annual tax expenditures by Congress for a number of popular items are estimated as follows ($ billions).

Home mortgage interest deduction	$ 89
Exclusion of the first $250,000/$500,000 gain on sale of a personal residence	30
Deferral of corporate income before repatriation	32
Capital gains from investments	24
Basis step-up at death	22
Exclusion for employer-provided health insurance fringe benefit	131
Child tax credit	28
State/local taxes deduction	78
Exclusion of retirement account earnings	118

- In the typical tax year, the IRS receives about 20 million Forms 1040EZ and about 25 million Forms 1040A.
- The typical Form 1040 requires 7.25 hours to gather records and assemble the return, and 6.25 hours to prepare the form and attachments. The estimated cost of complying with tax rules is $225 billion per year.
- The Internal Revenue Code is about 3.5 million words long, and the Regulations require another 8 million words. Combined, these documents are 12 times the length of Shakespeare's combined works and 15 times the length of the King James Bible.
- In filing Federal income tax returns, a majority of all individual taxpayers at every income level employ a professional tax preparer.

STATUTORY SOURCES OF THE TAX LAW

Origin of the Internal Revenue Code

Before 1939, the statutory provisions relating to taxation were contained in the individual revenue acts enacted by Congress. The inconvenience and confusion that resulted from dealing with many separate acts led Congress to codify all of the Federal tax laws. Known as the Internal Revenue Code of 1939, this codification arranged all Federal tax provisions in a logical sequence and placed them in a separate part of the Federal statutes. A further rearrangement took place in 1954 and resulted in the Internal Revenue Code of 1954, which continued in effect until it was replaced by the Internal Revenue Code of 1986.[1]

Now, statutory amendments to the tax law are integrated into the existing Code. Thus, subsequent tax legislation, such as the Economic Stimulus Act of 2008, the Food, Conservation, and Energy Act of 2008, the Housing Assistance Tax Act of 2008, and the American Recovery and Reinvestment Tax Act of 2009, becomes part of the Internal Revenue Code of 1986.

The Legislative Process

Federal tax legislation generally originates in the House of Representatives, where it first is considered by the House Ways and Means Committee. Tax bills can originate in the Senate if they are attached as riders to other legislative proposals. If acceptable

[1]Aside from changes due to a large tax act, the organization of the Internal Revenue Code of 1986 is not substantively different from the organization of the 1954 Code. In contrast, the numbering scheme of sections in the 1939 Code differs from that used in the 1954 Code.

to the committee, the proposed bill is referred to the entire House of Representatives for approval or disapproval. Approved bills are sent to the Senate, where they initially are considered by the Senate Finance Committee.

The next step is referral from the Senate Finance Committee to the entire Senate. Assuming no disagreement between the House and Senate, passage by the Senate means referral to the President for approval or veto. If the bill is approved or if the President's veto is overridden, the bill becomes law and part of the Internal Revenue Code.

When the Senate version of the bill differs from that passed by the House, the Conference Committee, which includes members of both the House Ways and Means Committee and the Senate Finance Committee, is called upon to resolve the differences. House and Senate versions of major tax bills frequently differ. One reason bills often are changed in the Senate is that each senator has considerable latitude to make amendments when the Senate as a whole is voting on a bill referred to it by the Senate Finance Committee. In contrast, the entire House of Representatives either accepts or rejects what is proposed by the House Ways and Means Committee, and changes from the floor are rare.

The deliberations of the Conference Committee usually produce a compromise between the two versions, which is then voted on by both the House and the Senate. If both bodies accept the revised bill, it is referred to the President for approval or veto. The typical legislative process dealing with tax bills is summarized in Figure 2.1.

FIGURE 2.1 Legislative Process for Tax Bills

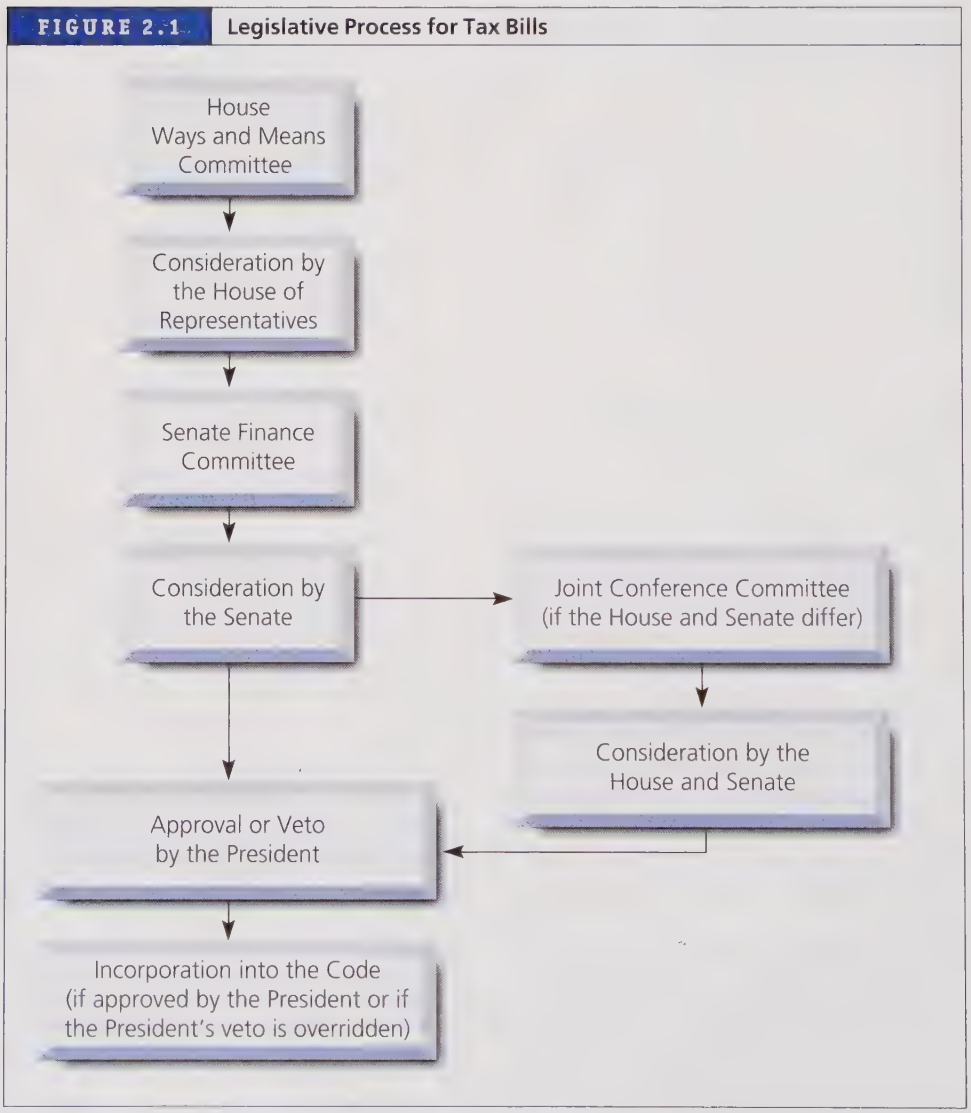
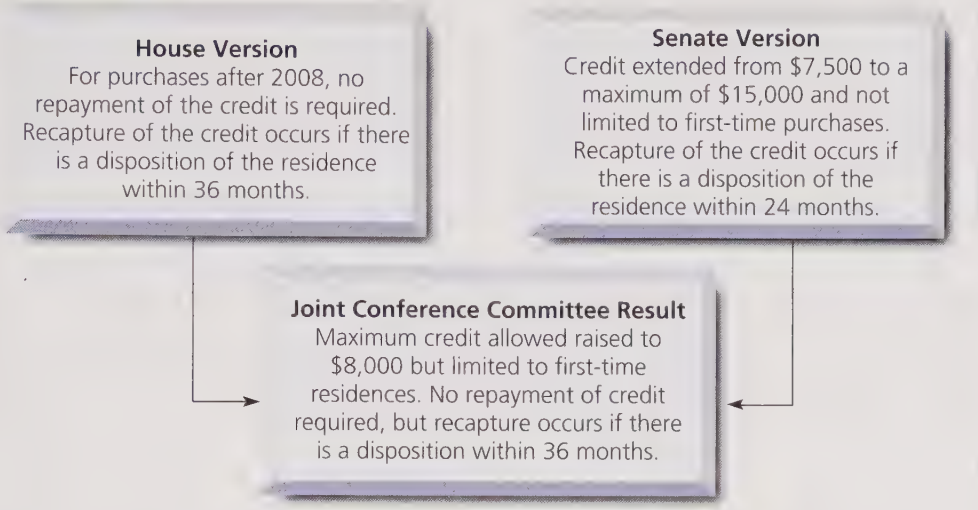


FIGURE 2.2 Example of Compromise in the Conference Committee



The role of the Conference Committee indicates the importance of compromise in the legislative process. As an example of the practical effect of the compromise process, consider what happened with amendments to the first-time homebuyer credit in the American Recovery and Reinvestment Tax Act (ARRTA) of 2009 (see Figure 2.2).

Referrals from the House Ways and Means Committee, the Senate Finance Committee, and the Conference Committee usually are accompanied by *Committee Reports*. These Committee Reports often explain the provisions of the proposed legislation and are therefore a valuable source for ascertaining the *intent of Congress*. What Congress had in mind when it considered and enacted tax legislation is the key to interpreting legislation. Since Regulations interpreting new legislation normally are not issued immediately after a statute is enacted, taxpayers and the courts look to Committee Reports to determine congressional intent.

Arrangement of the Code

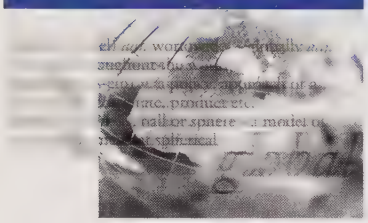
The Internal Revenue Code is found in Title 26 of the U.S. Code. Here is a partial table of contents.

Subtitle A. Income Taxes
  Chapter 1. Normal Taxes and Surtaxes
    Subchapter A. Determination of Tax Liability
      Part I. Tax on Individuals
        Sections 1–5
      Part II. Tax on Corporations
        Sections 11–12

In referring to a provision of the Code, the tax professional usually cites the Section number. In referring to § 2(a) (dealing with the status of a surviving spouse), for example, it is unnecessary to include Subtitle A, Chapter 1, Subchapter A, Part I. Merely mentioning § 2(a) suffices, since the Section numbers run consecutively and do not begin again with each new Subtitle, Chapter, Subchapter, or Part. Not all Code Section numbers are used, however. Part I ends with § 5 and Part II starts with § 11 (at present there are no §§ 6, 7, 8, 9, and 10).[2]

[2]When the Code was drafted, Section numbers were intentionally omitted so that later changes could be incorporated into the Code without disrupting its organization. When Congress does not leave enough space, subsequent Code Sections are given A, B, C, etc., designations. A good example is the treatment of §§ 280A through 280H.

GLOBAL Tax Issues



Tax Treaties

The United States has entered into treaties with most of the major Western and Asian countries of the world to eliminate possible double taxation. For example, nonresident alien students wishing to claim exemption from taxation are required to provide an information statement as set forth in several Revenue Procedures. The withholding agent must also certify the form.

Chinese students are required to prepare a four-part statement under treaty Article 20. Part 3 of the student's statement is as follows.

> I will receive compensation for personal services performed in the United States. This compensation qualifies for exemption from withholding of Federal income tax under the tax treaty between the United States and the People's Republic of China in an amount not in excess of $5,000 for any taxable year.

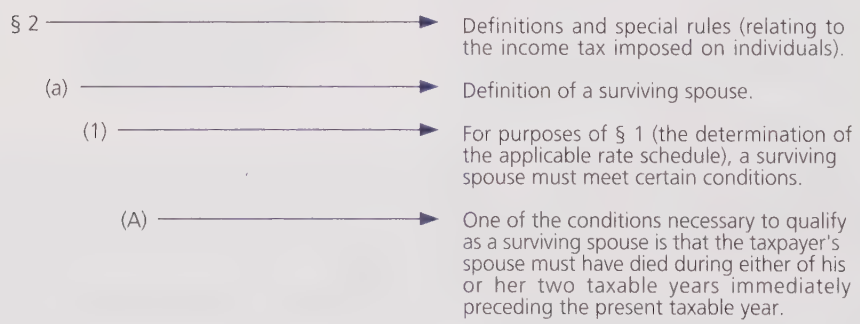
Tax practitioners commonly refer to certain areas of income tax law by Subchapter designation. Some of the more common Subchapter designations include Subchapter C ("Corporate Distributions and Adjustments"), Subchapter K ("Partners and Partnerships"), and Subchapter S ("Tax Treatment of S Corporations and Their Shareholders"). Particularly in the last situation, it is much more convenient to describe the effect of the applicable Code provisions (§§ 1361–1379) as "Subchapter S" than as the "Tax Treatment of S Corporations and Their Shareholders."

Citing the Code

Code Sections often are broken down into subparts.[3] Section 2(a)(1)(A) serves as an example.



Broken down by content, a citation for Code § 2(a)(1)(A) appears as follows.



[3]Some Code Sections do not have subparts. See, for example, §§ 211 and 241.

[4]Some Code Sections omit the subsection designation and use, instead, the paragraph designation as the first subpart. See, for example, §§ 212(1) and 1222(1).

Throughout the text, references to the Code Sections are in the form given above. The symbols "§" and "§§" are used in place of "Section" and "Sections." The following table illustrates the format used in the text.

Complete Reference	Text Reference
Section 2(a)(1)(A) of the Internal Revenue Code of 1986	§ 2(a)(1)(A)
Sections 1 and 2 of the Internal Revenue Code of 1986	§§ 1 and 2
Section 2 of the Internal Revenue Code of 1954	§ 2 of the Internal Revenue Code of 1954
Section 12(d) of the Internal Revenue Code of 1939[5]	§ 12(d) of the Internal Revenue Code of 1939

Effect of Treaties

The United States signs certain tax treaties (sometimes called tax conventions) with foreign countries to render mutual assistance in tax enforcement and to avoid double taxation. These treaties affect transactions involving U.S. persons and entities operating or investing in a foreign country, as well as persons and entities of a foreign country operating or investing in the United States. Although these bilateral agreements are not codified in any one source, they are published in various Internal Revenue Service publications as well as in privately published tax services.

Neither a tax law nor a tax treaty automatically takes precedence. When there is a direct conflict, the most recent item will take precedence. With certain exceptions, a taxpayer must disclose on the tax return any position where a treaty overrides a tax law.[6] There is a $1,000 per *failure to disclose* penalty for individuals and a $10,000 per failure to disclose penalty for C corporations.[7]

ADMINISTRATIVE SOURCES OF THE TAX LAW

The administrative sources of the Federal tax law can be grouped as follows: Treasury Department Regulations, Revenue Rulings and Revenue Procedures, and various other administrative pronouncements (see Exhibit 2.1). All are issued by either the U.S. Treasury Department or the IRS.

Treasury Department Regulations

Regulations are issued by the U.S. Treasury Department under authority granted by Congress.[8] Usually interpretive by nature, they provide taxpayers with considerable guidance on the meaning and application of the Code and often include examples. Regulations carry considerable authority as the official interpretation of tax statutes. They are an important factor to consider in complying with the tax law.

Treasury Regulations are arranged in the same sequence as the Code. A number is added at the beginning, however, to indicate the type of tax or other matter to which they relate. For example, the prefix 1 designates the Regulations under the income tax law. Thus, the Regulations under Code § 2 would be cited as Reg. § 1.2, with subparts added for further identification. The numbering pattern of these subparts often has no correlation with the Code subsections. The prefix 20 designates estate tax Regulations, 25 addresses gift tax Regulations, 31 relates to employment taxes, and 301 refers to procedure and administration. This list is not all-inclusive. Reg. § 1.351–1(a)(2) is an example of a citation.

[5] Section 12(d) of the Internal Revenue Code of 1939 is the predecessor to § 2 of the Internal Revenue Codes of 1954 and 1986.

[6] § 7852(d).

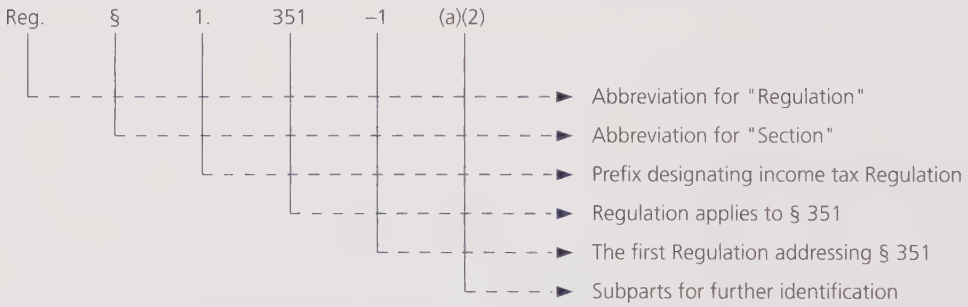
[7] § 6712(a).

[8] § 7805.

EXHIBIT 2-1 Administrative Sources

Source	Location	Authority***
Regulations	*Federal Register** *Internal Revenue Bulletin* *Cumulative Bulletin*	Force and effect of law. May be cited as precedent.
Temporary Regulations	*Federal Register** *Internal Revenue Bulletin* *Cumulative Bulletin*	May be cited as a precedent.
Proposed Regulations	*Federal Register** *Internal Revenue Bulletin* *Cumulative Bulletin*	Preview of final Regulations. Not yet a precedent.
Revenue Rulings Revenue Procedures Treasury Decisions Actions on Decisions	*Internal Revenue Bulletin*** *Cumulative Bulletin*	IRS interpretation only. Weak precedent.
General Counsel Memoranda Technical Advice Memoranda	*Tax Analysts' Tax Notes* RIA's *Internal Memoranda of the IRS* CCH's *IRS Position Reporter*	IRS interpretation only. Weak precedent.
Letter Rulings	Research Institute of America and Commerce Clearing House tax services**	Applicable only to taxpayer addressed. May not be cited as precedent.

*Final, Temporary, and Proposed Regulations are published in soft-cover form and online by several publishers.
**Revenue Rulings, Revenue Procedures, and letter rulings also are published online by several publishers.
***Each of these sources may be substantial authority for purposes of the accuracy-related penalty in § 6662.



New Regulations and changes in existing Regulations usually are issued in proposed form before they are finalized. The interval between the proposal of a Regulation and its finalization permits taxpayers and other interested parties to comment on the propriety of the proposal. These comments usually are provided in writing, but oral comments can be offered at hearings held by the IRS on the Regulations in question pursuant to a public notice. This practice of notice-and-comment is a major distinction between Regulations and other forms of Treasury guidance such as Revenue Rulings, Revenue Procedures, and the like.

Proposed Regulations under Code § 2, for example, are cited as Prop.Reg. § 1.2. The Tax Court indicates that Proposed Regulations carry little weight—no more than a position advanced in a written brief prepared by a litigating party before the Tax Court.[9]

The Treasury Department issues **Temporary Regulations** relating to matters where immediate guidance is important. These Regulations are issued without the comment period required for Proposed Regulations. Temporary Regulations have the

[9] *F. W. Woolworth Co.*, 54 T.C. 1233 (1970); *Harris M. Miller*, 70 T.C. 448 (1978); and *James O. Tomerlin Trust*, 87 T.C. 876 (1986).



Changing the Face of Russia

Peter the Great, the ruler of Russia from 1682 to 1725, imposed a tax on beards (except for clergy) because he felt that beards were "unnecessary, uncivilized, and ridiculous." If an individual did not pay the tax, a tax official would scrape off the beard. Without warning Peter himself would take a straight razor to the faces of bearded men appearing before him. When Peter attended a ceremony or banquet, anyone arriving with a beard would depart without it.

same authoritative value as final Regulations and may be cited as precedents. Temporary Regulations also are issued as Proposed Regulations and automatically expire within three years after the date of their issuance.[10]

Proposed, Temporary, and **Final Regulations** are published in the *Federal Register*, the *Internal Revenue Bulletin*, and major tax services.

Regulations may also be classified as *legislative*, *interpretive*, or *procedural*. This classification scheme is discussed later in the chapter.

Revenue Rulings and Revenue Procedures

Revenue Rulings are official pronouncements of the National Office of the IRS.[11] Like Regulations, they are designed to provide interpretation of the tax law. However, they do not carry the same legal force and effect as Regulations and usually deal with more restricted problems. In addition, Regulations are approved by the Secretary of the Treasury, whereas Revenue Rulings generally are not.

Both Revenue Rulings and Revenue Procedures serve an important function in providing *guidance* to IRS personnel and taxpayers in handling routine tax matters. Revenue Rulings and Revenue Procedures generally apply retroactively and may be revoked or modified by subsequent rulings or procedures, Regulations, legislation, or court decisions.

Revenue Rulings typically provide one or more examples of how the IRS would apply a law to specific fact situations. Revenue Rulings may arise from technical advice memoranda of the IRS, court decisions, suggestions from tax practitioner groups, and various tax publications. A Revenue Ruling also may arise from a specific taxpayer's request for a letter ruling. If the IRS believes that a taxpayer's request for a letter ruling deserves official publication due to its widespread impact, the letter ruling is converted into a Revenue Ruling and issued for the information and guidance of taxpayers, tax practitioners, and IRS personnel. Names, identifying descriptions, and money amounts are changed to conceal the identity of the requesting taxpayer.

Revenue Procedures are issued in the same manner as Revenue Rulings, but deal with the internal management practices and procedures of the IRS. Familiarity with these procedures increases taxpayer compliance and helps make the administration of the tax laws more efficient. The failure of a taxpayer to follow a Revenue Procedure can result in unnecessary delay or, in a discretionary situation, can cause the IRS to decline to act on behalf of the taxpayer.

Some recent Revenue Procedures dealt with the following matters.

- Deduction limits on luxury automobile depreciation.
- Revised procedures for the issuance of letter rulings.
- Automatic consent procedure for a change in accounting method.
- Inflation-adjusted amounts for various Code provisions.

Revenue Rulings and Revenue Procedures are published weekly by the U.S. Government in the *Internal Revenue Bulletin* (I.R.B.). Semiannually, the *Internal Revenue*

[10] § 7805(e).

[11] § 7805(a).

Bulletins for a six-month period are gathered together and published as the *Cumulative Bulletin* (C.B.).[12]

The proper form for citing Rulings and Procedures depends on whether the item has been published in the *Cumulative Bulletin* or is available only in I.R.B. form. Consider, for example, the following sequence.

Temporary Citation
Rev.Rul. 2009–19, 2009–28 I.R.B. 111.
Explanation: Revenue Ruling Number 19, appearing on page 111 of the 28th weekly issue of the *Internal Revenue Bulletin* for 2009.

Permanent Citation
Rev.Rul. 2009–19, 2009–2 C.B. 111.
Explanation: Revenue Ruling Number 19, appearing on page 111 of Volume 2 of the *Cumulative Bulletin* for 2009.

Until the first volume of the 2009 *Cumulative Bulletin* is published, the I.R.B. citation is used. After the publication of the *Cumulative Bulletin*, the C.B. citation is preferred. Revenue Rulings and other tax resources may be found on Tax Almanac, a free online resource from Intuit at **www.taxalmanac.org**.

Note that the page reference of 111 is the same for both the I.R.B. (temporary) and C.B. (permanent) versions of the citation. The IRS numbers the pages of the I.R.B.s consecutively for each six-month period so as to facilitate their conversion to C.B. form. Revenue Procedures are cited in the same manner, except that "Rev.Proc." is substituted for "Rev.Rul."

Letter Rulings

Letter rulings are issued for a fee upon a taxpayer's request. They describe how the IRS will treat a *proposed* transaction for tax purposes. Letter rulings can be useful to taxpayers who wish to be certain of how a transaction will be taxed before proceeding with it. Letter rulings allow taxpayers to avoid unexpected tax costs. The procedure for requesting a ruling can be quite cumbersome, although it sometimes is the most effective way to carry out tax planning. The IRS limits the issuance of individual rulings to restricted, pre-announced areas of taxation and generally will not rule on situations that are fact-intensive. Thus, a ruling may not be obtained on many of the problems that are particularly troublesome to taxpayers.[13]

The IRS makes letter rulings available for public inspection after identifying details are deleted.[14] Published digests of private letter rulings are found in RIA's *Private Letter Rulings*, BNA's *Daily Tax Reports*, and Tax Analysts' *Tax Notes*. *IRS Letter Rulings Reports* (published by Commerce Clearing House) contains both digests and full texts of all letter rulings. *Letter Ruling Review* (published by Tax Analysts), a monthly publication, selects and discusses the most important of the approximately 40 letter rulings issued each week. In addition, computerized databases of letter rulings are available through several private publishers.

Letter rulings are issued multidigit file numbers, which indicate the year and week of issuance as well as the number of the ruling during that week. Consider, for example, Ltr.Rul. 200916013, which gives a taxpayer an additional 60 days from the date of the ruling to make a late election to file Form 8832.

2009	16	013
Year 2009	Issued during the 16th week of 2009	13th ruling issued during the 16th week

[12]Usually, only two volumes of the *Cumulative Bulletin* are published in the typical year. However, when Congress has enacted major tax legislation, additional volumes may be published containing the congressional Committee Reports supporting the Revenue Act.

[13]The first *Internal Revenue Bulletin* issued each year contains a list of areas in which the IRS will not issue advance rulings. This list may be modified throughout the year. See, for example, Rev.Proc. 2010–1, 2010–2 I.R.B. 1.

[14]§ 6110.

Other Administrative Pronouncements

Treasury Decisions (TDs) are issued by the Treasury Department to promulgate new Regulations, amend or otherwise change existing Regulations, or announce the position of the Government on selected court decisions. Like Revenue Rulings and Revenue Procedures, TDs are published initially in the *Internal Revenue Bulletin* and subsequently transferred to the *Cumulative Bulletin.*

The IRS publishes other administrative communications in the *Internal Revenue Bulletin,* such as Announcements, Notices, Proposed Regulations, Termination of Exempt Organization Status, Practitioner Disciplinary Actions, and Prohibited Transaction Exemptions.

Like letter rulings, **determination letters** are issued at the request of taxpayers and provide guidance on the application of the tax law. They differ from letter rulings in that the issuing source is an IRS executive, rather than the National Office of the IRS. Further, determination letters usually involve *completed* (as opposed to proposed) transactions. Determination letters are not published regularly, and they are released officially only to the party making the request.

The shareholders of Red Corporation and Green Corporation want assurance that the consolidation of their corporations into Blue Corporation will be a nontaxable reorganization. The proper approach is to ask the National Office of the IRS to issue a letter ruling concerning the income tax effect of the proposed transaction. ■

Chris operates a barber shop in which he employs eight barbers. To comply with the rules governing income tax and payroll tax withholdings, Chris wants to know whether the barbers working for him are employees or independent contractors. The proper procedure is to request a determination letter on their status from the IRS. ■

The National Office of the IRS releases **Technical Advice Memoranda (TAMs)** weekly. TAMs resemble letter rulings in that they give the IRS's determination of an issue. Letter rulings, however, are responses to requests by taxpayers, whereas TAMs are issued by the National Office of the IRS in response to questions raised by IRS field personnel during audits. TAMs deal with completed rather than proposed transactions and often are requested for questions relating to exempt organizations and employee plans.

The law requires that several internal memoranda that constitute the working law of the IRS be released. TAMs and General Counsel Memoranda (GCMs) are not officially published, and the IRS indicates that they may not be cited as precedent by taxpayers.[15] However, these working documents do explain the IRS's position on various issues.

JUDICIAL SOURCES OF THE TAX LAW

The Judicial Process in General

After a taxpayer has exhausted some or all of the remedies available within the IRS (no satisfactory settlement has been reached at the agent level or at the Appeals Division level), the dispute can be taken to the Federal courts. The dispute first is considered by a **court of original jurisdiction** (known as a trial court), with any appeal (either by the taxpayer or the IRS) taken to the appropriate appellate court. In most situations, the taxpayer has a choice of four trial courts: a **District Court**, the **Court of Federal Claims**, the **Tax Court**, or the **Small Cases Division** of the Tax Court. The court system for Federal tax litigation is illustrated in Figure 2.3.

The broken line between the Tax Court and the Small Cases Division indicates that there is no appeal from the Small Cases Division. Decisions from the Small Cases

[15]These are unofficially published by the sources listed in Exhibit 2.1. Internal memoranda may constitute substantial authority for purposes of the § 6662 accuracy-related penalty. Notice 90–20, 1990–1 C.B. 328.

Division have no precedential value. Some of these cases are found on the U.S. Tax Court website. They may not be relied upon by other taxpayers or even by the taxpayer in question in subsequent years. The jurisdiction of the Small Cases Division is limited to cases involving tax, interest, and penalty amounts of $50,000 or less.

DIGGING DEEPER 1

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

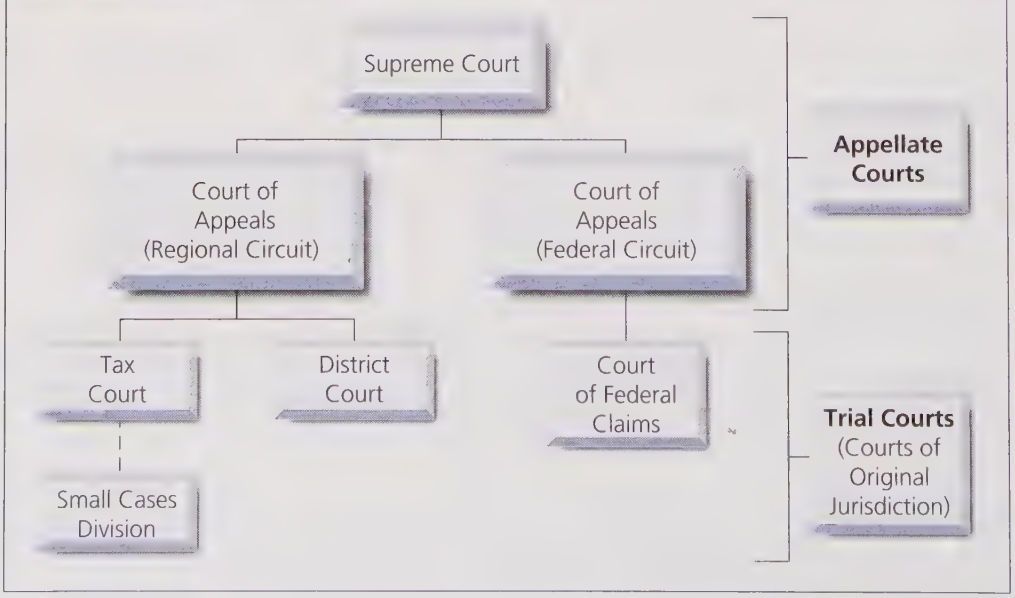
Knowledge of several terms is important in understanding court decisions. The plaintiff is the party requesting action in a court, and the defendant is the party against whom the suit is brought. Sometimes a court uses the terms *petitioner* and *respondent*. In general, "petitioner" is a synonym for "plaintiff," and "respondent" is a synonym for "defendant." At the trial court level, a taxpayer usually is the plaintiff (or petitioner), and the government is the defendant (or respondent). If the taxpayer wins and the Government appeals as the new petitioner (or appellant), the taxpayer now is the respondent.

Trial Courts

The differences among the various trial courts (courts of original jurisdiction) can be summarized as follows.

- *Number of courts.* There is only one Court of Federal Claims and only one Tax Court, but there are many District Courts. The taxpayer does not select the District Court that will hear the dispute but must sue in the one that has jurisdiction where the taxpayer resides.
- *Number of judges.* A case tried in a District Court is heard before only 1 judge. The Court of Federal Claims has 16 judges, and the Tax Court has 19 regular judges. The entire Tax Court, however, reviews a case (the case is sent to court conference) only when important or novel tax issues are involved. Most cases are heard and decided by only 1 of the 19 judges.
- *Location.* The Court of Federal Claims meets most often in Washington, D.C., while a District Court meets at a prescribed seat for the particular district. Each state has at least one District Court, and many of the populous states have more than one. Choosing the District Court usually minimizes the inconvenience and expense of traveling for the taxpayer and his or her counsel. The Tax Court is based in Washington, D.C., but various judges

FIGURE 2.3 Federal Judicial System



travel to different parts of the country and hear cases at predetermined locations and dates. This procedure eases the distance problem for the taxpayer, but it can mean a delay before the case comes to trial.

- *Jurisdiction of the Court of Federal Claims.* The Court of Federal Claims has jurisdiction over any claim against the United States that is based upon the Constitution, any Act of Congress, or any Regulation of an executive department. Thus, the Court of Federal Claims hears nontax litigation as well as tax cases.
- *Jurisdiction of the Tax Court and District Courts.* The Tax Court hears only tax cases and is the most popular forum. The District Courts hear a wide variety of nontax cases, including drug crimes and other Federal violations, as well as tax cases. For this reason, some people suggest that the Tax Court has more expertise in tax matters.
- *Jury trial.* The only court in which a taxpayer can obtain a jury trial is a District Court. Juries can decide only questions of fact and not questions of law. Therefore, taxpayers who choose the District Court route might not request a jury trial. If a jury trial is not elected, the judge decides all issues. A District Court decision is controlling only in the district in which the court has jurisdiction.
- *Payment of deficiency.* Before the Court of Federal Claims or a District Court can have jurisdiction, the taxpayer must pay the tax deficiency assessed by the IRS and then sue for a refund. If the taxpayer wins (assuming no successful appeal by the Government), the tax paid plus appropriate interest is recovered. Jurisdiction in the Tax Court, however, usually is obtained without first paying the assessed tax deficiency.

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

2 DIGGING DEEPER

- *Appeals.* Appeals from a District Court or a Tax Court decision go to the Court of Appeals for the circuit in which the taxpayer resides. Appeals from the Court of Federal Claims go to the Court of Appeals for the Federal Circuit. Few Tax Court cases are appealed, and when appeals are made, most are filed by the taxpayer rather than the IRS.
- *Bankruptcy.* When a taxpayer files a bankruptcy petition, the IRS, like other creditors, is prevented from taking action against the taxpayer. Sometimes a bankruptcy court settles a tax claim.

For a summary of the Federal trial courts, see Concept Summary 2.1.

Appellate Courts

The losing party can appeal a trial court decision to a **Circuit Court of Appeals**. The 11 geographic circuits, the circuit for the District of Columbia, and the Federal Circuit[16] are shown in Figure 2.4.

Process and Outcomes If the government loses at the trial court level (District Court, Tax Court, or Court of Federal Claims), it need not (and frequently does not) appeal. The fact that an appeal is not made, however, does not indicate that the IRS agrees with the result and will not litigate similar issues in the future. The IRS may decide not to appeal for a number of reasons. First, its current litigation load may be heavy. As a consequence, the IRS may decide that available personnel should be assigned to other, more important cases. Second, the IRS may not appeal for strategic reasons. For example, the taxpayer may be in a sympathetic position, or the facts may be particularly strong in his or her favor. In that event, the IRS may wait for a weaker case to test the legal issues

[16]The Court of Appeals for the Federal Circuit hears decisions appealed from the Court of Federal Claims.

CONCEPT SUMMARY 2.1

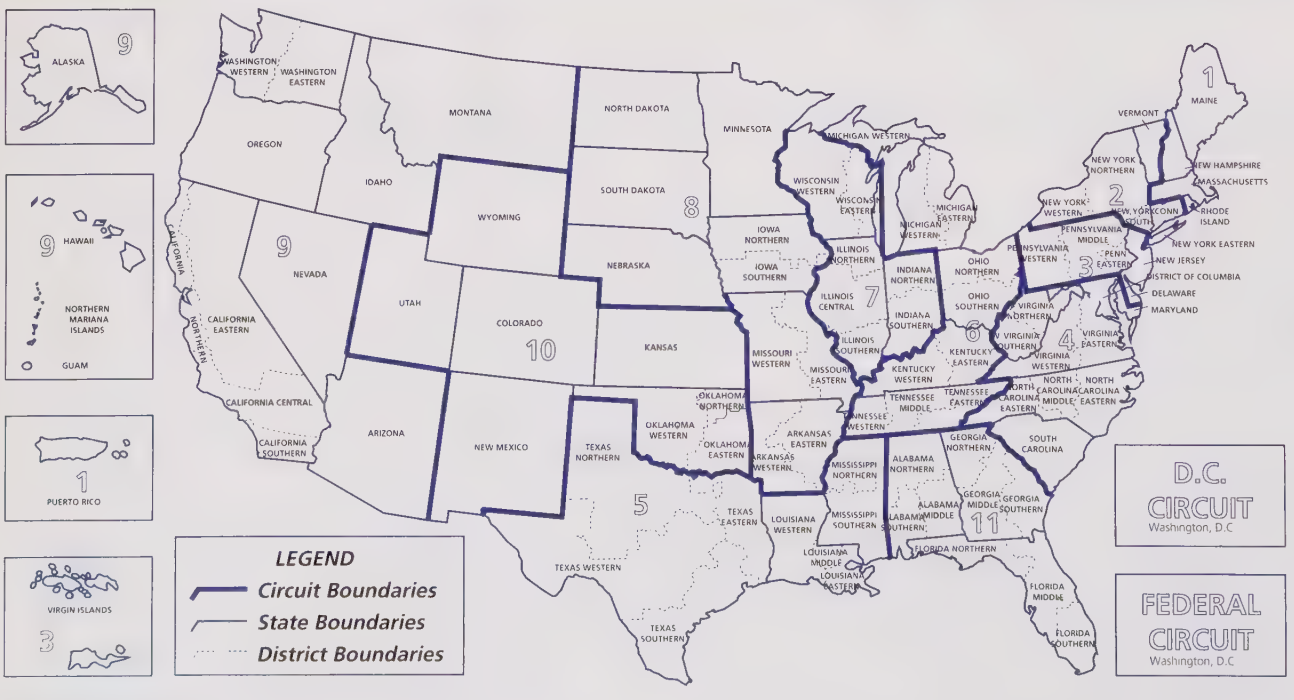
Federal Judicial System: Trial Courts

Issue	Tax Court	District Court	Court of Federal Claims
Number of judges per court	19	1 per case	16
Payment of deficiency before trial	No	Yes	Yes
Jury trial available	No	Yes	No
Types of dispute	Tax cases only	Mostly criminal and civil issues	Claims against the United States
Jurisdiction	Nationwide	Location of taxpayer	Nationwide
IRS acquiescence policy	Yes	Yes	Yes
Appeal is to	U.S. Court of Appeals	U.S. Court of Appeals	Court of Appeals for the Federal Circuit

involved. Third, if the appeal is from a District Court or the Tax Court, the Court of Appeals of jurisdiction could have some bearing on whether the IRS decides to pursue an appeal. Based on past experience and precedent, the IRS may conclude that the chance for success on a particular issue might be more promising in another Court of Appeals. If so, the IRS will wait for a similar case to arise in a different jurisdiction.

The role of appellate courts is limited to a review of the record of trial compiled by the trial courts. Thus, the appellate process usually involves a determination of whether the trial court applied the proper law in arriving at its decision, rather than a consideration of the trial court's factual findings.

FIGURE 2.4 The Federal District Courts and Circuit Courts of Appeals



ADMINISTRATIVE OFFICE OF THE UNITED STATES SUPREME COURT
APRIL 1988

An appeal can have any of a number of possible outcomes. The appellate court may let stand (affirm) or overturn (reverse) the lower court's finding, or it may send the case back for further consideration (remand). When many issues are involved, a mixed result is not unusual. Thus, the lower court may be affirmed (*aff'd.*) on Issue A and reversed (*rev'd.*) on Issue B, while Issue C is remanded (*rem'd.*) for additional fact finding.

When more than one judge is involved in the decision-making process, disagreements are not uncommon. In addition to the majority view, one or more judges may concur (agree with the result reached but not with some or all of the reasoning) or dissent (disagree with the result). In any one case, the majority view controls. But concurring and dissenting views can influence other courts or, at some subsequent date when the composition of the court has changed, even the same court.

Other Rules and Strategies The Federal Circuit at the appellate level provides a taxpayer with an alternative forum to the Court of Appeals of his or her home circuit. When a particular circuit has issued an adverse decision, the taxpayer may prefer the Court of Federal Claims, since any appeal will be to the Court of Appeals for the Federal Circuit.

District Courts, the Tax Court, and the Court of Federal Claims must abide by the **precedents** set by the Court of Appeals of their jurisdiction. A particular Court of Appeals need not follow the decisions of another Court of Appeals. All courts, however, must follow decisions of the **Supreme Court**.

This pattern of appellate precedents raises an issue for the Tax Court. Because the Tax Court is a national court, it decides cases from all parts of the country. Appeals from its decisions, however, go to all of the Courts of Appeals except the Court of Appeals for the Federal Circuit. Accordingly, identical Tax Court cases might be appealed to different circuits with different results. As a result of *Golsen*,[17] the Tax Court will not follow its own precedents in a subsequent case if the Court of Appeals with jurisdiction over the taxpayer in question has previously reversed the Tax Court on the specific issue at hand.

EXAMPLE 3

Emily lives in Texas and sues in the Tax Court on Issue A. The Fifth Circuit Court of Appeals is the appellate court with jurisdiction. The Fifth Circuit has already decided, in a case involving similar facts but a different taxpayer, that Issue A should be resolved against the Government. Although the Tax Court feels that the Fifth Circuit is wrong, under its *Golsen* policy it will render judgment for Emily. Shortly thereafter, in a comparable case, Rashad, a resident of New York, sues in the Tax Court on Issue A. The Second Circuit Court of Appeals, the appellate court with jurisdiction in New York, never has expressed itself on Issue A. Presuming the Tax Court has not reconsidered its position on Issue A, it will decide against Rashad. Thus, it is possible for two taxpayers suing in the same court to end up with opposite results merely because they live in different parts of the country. ■

Appeal to the Supreme Court is not automatic. It must be applied for via a **Writ of Certiorari**. If the Court agrees to hear the case, it will grant the Writ (*Cert. granted*). Most often, it declines to hear the case (*Cert. denied*). In fact, the Supreme Court rarely hears tax cases. The Court usually grants certiorari to resolve a conflict among the Courts of Appeals (e.g., two or more appellate courts have opposing positions on a particular issue) or where the tax issue is extremely important. The granting of a *Writ of Certiorari* indicates that at least four members of the Supreme Court believe that the issue is of sufficient importance to be heard by the full Court.

Judicial Citations

Court decisions are an important source of tax law. The ability to locate a case and to cite it is a must in working with the tax law. Judicial citations usually follow a standard

[17] *Jack E. Golsen*, 54 T.C. 742 (1970).

pattern: case name, volume number, reporter series, page or paragraph number, court (where necessary), and the year of decision.

Judicial Citations—The Tax Court The Tax Court issues two types of decisions: Regular and Memorandum. The Chief Judge decides whether the opinion is issued as a Regular or Memorandum decision. The distinction between the two involves both substance and form. In terms of substance, *Memorandum* decisions deal with situations necessitating only the application of already established principles of law. *Regular* decisions involve novel issues not previously resolved by the court. In actual practice, however, this distinction is not always so clear. Be that as it may, both Regular and Memorandum decisions represent the position of the Tax Court and, as such, can be relied on by others.

Regular and Memorandum decisions issued by the Tax Court also differ in form. Memorandum decisions are not published officially, while Regular decisions are published by the U.S. Government in a series called *Tax Court of the United States Reports* (T.C.). Each volume of these *Reports* covers a six-month period (January 1 through June 30 and July 1 through December 31) and is given a succeeding volume number. But there is usually a time lag between the date a decision is rendered and the date it appears in official form. A temporary citation may be necessary to help the researcher locate a recent Regular decision. Consider, for example, the temporary and permanent citations for *Morton L. Ginsberg*, a decision filed on April 28, 2008.

Temporary Citation	*Morton L. Ginsberg*, 130 T.C. ___, No. 7 (2008). *Explanation:* Page number left blank because not yet known.
Permanent Citation	*Morton L. Ginsberg*, 130 T.C. 88 (2008). *Explanation:* Page number now available.

Both citations tell us that the case ultimately will appear in Volume 130 of the *Tax Court of the United States Reports*. Until this volume becomes available to the general public, however, the page number is left blank. Instead, the temporary citation identifies the case as being the 7th Regular decision issued by the Tax Court since Volume 129 ended. With this information, the decision easily can be located in either of the special Tax Court services published by Commerce Clearing House and Research Institute of America. Once Volume 130 is released, the permanent citation can be substituted and the number of the case dropped. Regular decisions and Memorandum decisions are published on the U.S. Tax Court website (**www.ustaxcourt.gov**).

Before 1943, the Tax Court was called the Board of Tax Appeals, and its decisions were published as the *United States Board of Tax Appeals Reports* (B.T.A.). These 47 volumes cover the period from 1924 to 1942. For example, the citation *Karl Pauli*, 11 B.T.A. 784 (1928) refers to the 11th volume of the *Board of Tax Appeals Reports*, page 784, issued in 1928.

If the IRS loses a decision, it may indicate whether it agrees or disagrees with the results reached by the court by publishing an **acquiescence** ("A" or "*Acq.*") or **nonacquiescence** ("NA" or "*Nonacq.*"), respectively. The acquiescence program is used where guidance is helpful, regardless of the court that issued the opinion. The acquiescence or nonacquiescence is published in the *Internal Revenue Bulletin* and the *Cumulative Bulletin* as an *Action on Decision*. The IRS can revoke an acquiescence retroactively.

Although Memorandum decisions were not published by the U.S. Government until recently, they were and continue to be published by Commerce Clearing House (CCH) and Research Institute of America (RIA). Consider, for example, the three different ways that *Nick R. Hughes* can be cited.

Nick R. Hughes, T.C.Memo. 2009–94
The 94th Memorandum decision issued by the Tax Court in 2009.

Nick R. Hughes, 97 TCM 1488
Page 1488 of Volume 97 of the CCH *Tax Court Memorandum Decisions*.

Nick R. Hughes, RIA T.C.Memo. ¶2009,094
Paragraph 2009,094 of the RIA *T.C. Memorandum Decisions*.

The third citation contains the same information as the first. Thus, the reference to ¶2009,094 indicates the following information about the case: year 2009, 94th T.C.Memo. decision of the year.

U.S. Tax Court Summary Opinions relate to decisions of the Tax Court's Small Cases Division. These opinions are published commercially, and on the U.S. Tax Court website, with the warning that they may not be treated as precedent for any other case. For example, *Donald Addie,* filed on August 25, 2009, is cited as follows.

Donald Addie, T.C. Summary Opinion 2009–129.

Judicial Citations—The District Courts, Court of Federal Claims, and Courts of Appeals District Court, Court of Federal Claims, and Court of Appeals decisions dealing with Federal tax matters are reported in both the CCH *U.S. Tax Cases* (USTC) and the RIA *American Federal Tax Reports* (AFTR) series.

District Court decisions, dealing with *both* tax and nontax issues, are also published by West Publishing Company in its *Federal Supplement Series* (F.Supp.). Volume 999, published in 1998, was the last volume of the Federal Supplement Series. West now uses the *Federal Supplement Second Series* (F.Supp.2d). A District Court case can be cited in three different forms.

Turner v. U.S., 2004–1 USTC ¶60,478 (D.Ct. N.Tex.).

Explanation: Reported in the first volume of the *U.S. Tax Cases* published by Commerce Clearing House for calendar year 2004 (2004–1) and located at paragraph 60,478 (¶60,478).

Turner v. U.S., 93 AFTR 2d 2004–686 (D.Ct. N.Tex.).

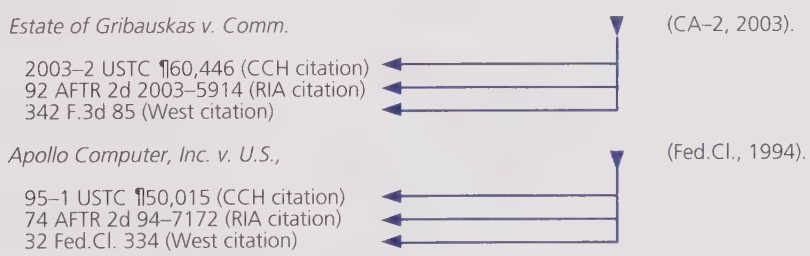
Explanation: Reported in the 93rd volume of the second series of the *American Federal Tax Reports* (AFTR 2d) published by RIA and beginning on page 686.

Turner v. U.S., 306 F.Supp.2d 668 (D.Ct. N.Tex., 2004).

Explanation: Reported in the 306th volume of the *Federal Supplement Second Series* (F.Supp.2d) published by West Publishing Company and beginning on page 668. The date reference is needed, as it is not a part of the earlier citation.

In all of the preceding citations, the name of the case is the same (Turner being the taxpayer), as are the references to the Northern District Court of Texas (D.Ct. N.Tex.) and the year the decision was rendered (2004).

Decisions of the Courts of Appeals are published in the USTCs, AFTRs, and the *Federal Second Series* (F.2d). Volume 999, published in 1993, was the last volume of the *Federal Second Series.* West now uses the *Federal Third Series* (F.3d). Decisions of the Court of Federal Claims are published in the USTCs, AFTRs, and the *Claims Court Reporter* (abbreviated as Cl.Ct.).



Gribauskas is a decision rendered by the Second Circuit Court of Appeals in 2003 (CA–2, 2003), while *Apollo Computer, Inc.* was issued by the Court of Federal Claims in 1994 (Fed.Cl., 1994), but published by CCH in 1995.

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft.**





Bridge to Public Policy

Sources of the Federal tax law reflect the general construct of the Federal government. The legislative branch issues the statutory tax law sources. The executive branch controls the administrative sources of the tax law, for the most part using the Department of the Treasury. The judicial branch issues various court decisions interpreting the tax law.

But the "checks and balances" called for by the U.S. Constitution are not so apparent in the implementation of the Federal tax law. Congressional committees often bury tax proposals that deserve greater disclosure and examination as sources of both revenue and public action. The "revenue neutrality" requirements that apply to many of the actions of Congress are avoided easily by applying "emergency" status to revenue and appropriation proposals. As a result, revenue-related language is often attached to numerous and diverse bills that are difficult for tax professionals to track.

Access to the judicial sources of the Federal tax law is prohibitively expensive for most taxpayers. And although the tendency to settle most litigation outside the court system may be cost-effective for all parties, it inhibits the abilities of tax researchers to identify trends in the evolution of the law. Further, the Supreme Court grants certiorari for tax cases so few times each year that the judicial system effectively includes only one trial court and then one appellate opportunity for the taxpayer.

Finally, the political process dictates that wide swings in enforcement initiatives and budgets will occur from year to year. Taxpayers must be able to predict how the law will be administered as they craft and execute their tax plans, but that becomes especially difficult when personnel turnover is common in the IRS and other tax-related agencies.

Federal tax law is a product of the rest of the governing process as it was designed long ago, but its current operations often make it a creature unto itself.

Judicial Citations—The Supreme Court Like all other Federal tax decisions (except those rendered by the Tax Court), Supreme Court decisions dealing with Federal tax matters are published by Commerce Clearing House in the USTCs and by RIA in the AFTRs. The U.S. Government Printing Office publishes all Supreme Court decisions in the *United States Supreme Court Reports* (U.S.), as do West Publishing Company in its *Supreme Court Reporter* (S.Ct.) and the Lawyer's Co-operative Publishing Company in its *United States Reports, Lawyer's Edition* (L.Ed.).

U.S. v. The Donruss Co., (USSC, 1969).

69–1 USTC ¶9167 (CCH citation)
23 AFTR 2d 69–418 (RIA citation)
89 S.Ct. 501 (West citation)
393 U.S. 297 (U.S. Government Printing Office citation)
21 L.Ed.2d 495 (Lawyer's Co-operative Publishing Co. citation)

The parenthetical reference (USSC, 1969) identifies the decision as having been rendered by the U.S. Supreme Court in 1969. In this text, the citations of Supreme Court decisions are limited to the CCH (USTC), RIA (AFTR), and West (S.Ct.) versions.

2.2 Working with the Tax Law—Tax Research

LO.2

Locate and work with the tax law and understand the tax research process.

Tax research is undertaken to determine the best available solution to a situation that has tax consequences. In the case of a completed transaction, the objective of the research is to determine the tax result of what has already taken place. For example, is the expenditure incurred by the taxpayer deductible or not deductible for tax purposes? When dealing with proposed transactions, tax research is concerned with the determination of possible alternative tax consequences to facilitate effective tax planning.

Tax research involves the following procedures.

- Identifying and refining the problem.
- Locating the appropriate tax law sources.
- Assessing the tax law sources.
- Arriving at the solution or at alternative solutions while giving due consideration to nontax factors.
- Effectively communicating the solution to the taxpayer or the taxpayer's representative.
- Following up on the solution (where appropriate) in light of new developments.

This process is depicted schematically in Figure 2.5. The broken lines indicate steps of particular interest when tax research is directed toward proposed, rather than completed, transactions.

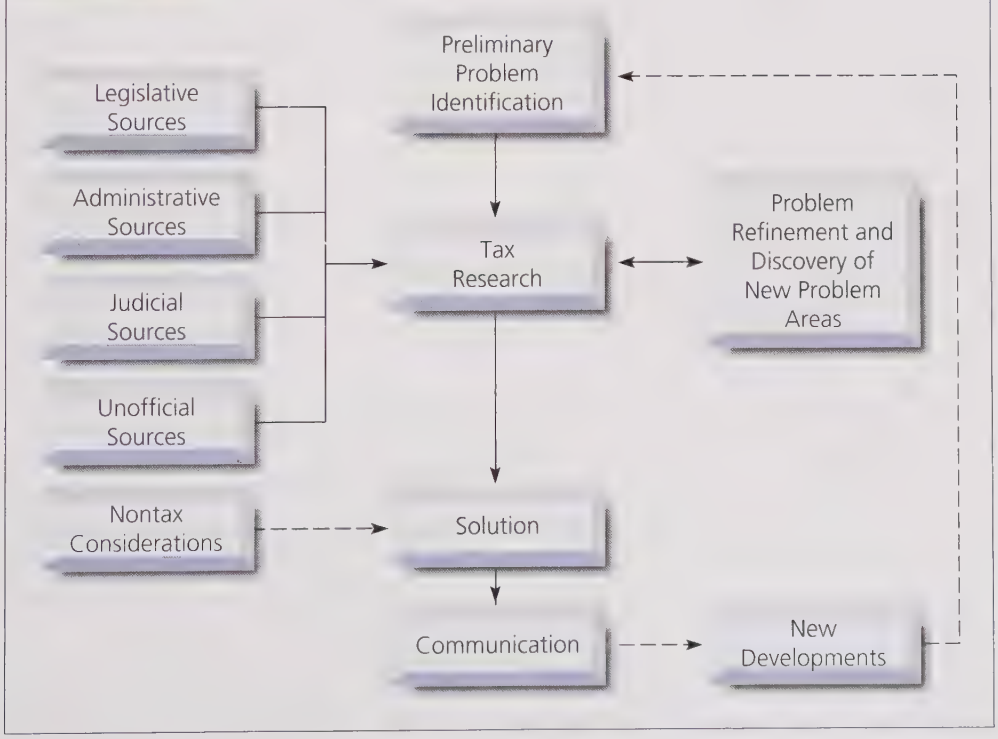
IDENTIFYING THE PROBLEM

Problem identification starts with a compilation of the relevant facts involved. In this regard, *all* of the facts that may have a bearing on the problem must be gathered, as any omission could modify the solution reached. To illustrate, consider what appears to be a very simple problem.

EXAMPLE 4

In reviewing their tax and financial situation, Fred and Megan, a married couple, notice that Fred's investment in Airways stock has declined from its purchase price of $8,000 to a current market value of $5,500. Megan wants to sell this stock now and claim the $2,500 loss ($5,500 value − $8,000 cost) as a deduction this year. Fred, however, believes that Airways Co. will yet prosper and does not want to part with its stock. Their daughter suggests that they sell the Airways Co. stock to Maple, Inc., a corporation owned equally by Fred and Megan. That way, they can claim the deduction this year while still holding the stock through their corporation. Will this suggestion work? ■

FIGURE 2.5 Tax Research Process





Bridge to Business Law

U.S. income tax laws change daily by the action of Congress, tax administrators, and the courts. This process matches the three-branch structure of the rest of the government, with the legislative, executive, and judicial branches each having a say in making tax law. But this distinction among the functions of government is perhaps less clear when it involves the tax law.

- Presidential vetoes of tax legislation are rare.
- The Tax Court is a creation of the Congress in the Internal Revenue Code, not of the U.S. Constitution.
- The cost of tax litigation and the time that it takes for a case to work its way through the judicial system render the courts unavailable to most taxpayers.

Under the U.S. Constitution, legislation involving government revenues must start in the House of Representatives. This provision likely was included so that the public would have greater control over those who want greater access to their pocketbooks. Several recent pieces of tax legislation, though, have been initiated as bills in the Senate. And during the years of the deepest Federal deficits, all bills introduced in both houses of Congress are required to be "revenue neutral" (i.e., they must include provisions by which the legislation's new programs will be paid for). In both houses, this has resulted in amendments to the Internal Revenue Code being attached to legislation involving clean air and water standards, child care programs, and product import and export limitations.

In a few cases, the courts considered a taxpayer challenge to the way this tax legislation was crafted. But so far the courts have failed to overturn any tax provisions solely because they were initiated in the Senate. The courts' rationale for this seemingly unconstitutional position is that (1) the House and its committees heard a full discussion of the proposal, and (2) too much time has passed since adoption of the legislation to easily un-wind it and undertake a refund procedure.

REFINING THE PROBLEM

Fred and Megan in Example 4 face three choices: (1) sell the Airways stock through their regular investment broker and get a deduction in the current year (Megan's plan); (2) continue to hold the Airways stock (Fred's plan); and (3) sell the Airways stock to a corporation owned 50–50 by Fred and Megan (their daughter's suggestion). The tax consequences of plans (1) and (2) are clear, but the question that Fred and Megan want to resolve is whether plan (3) will work as anticipated. Refining the problem further, can shareholders deduct a loss from the sale of an asset to a corporation that they control? Section 267(a)(1) indicates that losses from the sale of property between persons specified in § 267(b) are not deductible. This subsection lists 12 different relationships, including, in § 267(b)(2): "an individual and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual." Thus, if Fred and Megan each own 50 percent of Maple, neither owns *more than* 50 percent, as § 267(b) requires. Accordingly, the loss disallowance rule would not apply to Fred, and their daughter's suggestion would appear to be sound.

The language of the statute, however, indicates that any stock owned *directly or indirectly* by an individual is counted toward the 50 percent test. Might Megan's stock be considered owned "indirectly" by Fred? Further research is necessary. Section 267(c) contains rules for determining "constructive ownership of stock," or when stock owned by one person will be attributed to someone else. One of the rules in this subsection declares that an individual is considered to own any stock that is owned by that person's *family*, and family is defined in § 267(c)(4) as including a person's spouse, among others. Therefore, Megan's stock will be attributed to Fred, so that Fred is treated as owning all of the stock of Maple, Inc. As a result, § 267(a) would indeed apply, and no loss would be deductible if Fred sells his Airways stock to Maple. In short, the daughter's suggestion will not work.

LOCATING THE APPROPRIATE TAX LAW SOURCES

Once the problem is clearly defined, what is the next step? While it is a matter of individual judgment, most tax research begins with a keyword search of an online tax service. If the problem is not complex, the researcher may bypass the tax service and turn directly to the Internal Revenue Code and the Treasury Regulations. For the beginner, the latter procedure saves time and will solve many of the more basic problems. If the researcher does not have a personal copy of the Code or Regulations, access to the appropriate volume(s) of a tax service, an online service, or the Internet is necessary.[18] The major tax services and their publishers are:

Standard Federal Tax Reporter, Commerce Clearing House.
United States Tax Reporter, Research Institute of America.
Federal Tax Coordinator 2d, Research Institute of America.
Tax Management Portfolios, Bureau of National Affairs.

Working with Tax Services

In this text, it is not feasible to explain the use of any particular tax service—this ability can be obtained with experience. However, several important observations about the use of tax services cannot be overemphasized. First, always check for current developments. Online tax services are updated several times a day, and tax newsletters often feature highlights of recent tax law changes. Second, there is no substitute for the original source. Do not base a conclusion solely on a tax service's commentary. If a Code Section, Regulation, or case is vital to the research, read it.

Tax Periodicals

Various tax periodicals are another source of information. The use of tax periodicals often can shorten the research time needed to resolve a tax issue. If the article is relevant to the issue at hand, it may provide the references needed to locate the primary sources of the tax law that apply (e.g., citations to judicial decisions, Regulations, and other IRS pronouncements). Thus, the researcher obtains a "running start" in arriving at a solution to the problem.

The following are some of the more useful tax periodicals.

Journal of Taxation
Journal of International Taxation
Practical Tax Strategies
Estate Planning
Corporate Taxation
Business Entities
ria.thomsonreuters.com/Journals

The Tax Executive
www.tei.org

The Tax Adviser
aicpa.org/pubs/taxadv

The Tax Lawyer
www.law.georgetown.edu/journals/tax

The ATA Journal of Legal Tax Research
aaahq.org/ata/_ATAMenu/ATAPubJLTR.html

Trusts and Estates
trustsandestates.com

Journal of Passthrough Entities
TAXES—The Tax Magazine
tax.cchgroup.com/Books

Tax Notes
taxanalysts.com

ASSESSING TAX LAW SOURCES

Once a source has been located, the next step is to assess it in light of the problem at hand. Proper assessment involves careful interpretation of the tax law and consideration of its relevance and significance.

[18]Several of the major tax services publish paperback editions of the Code and Treasury Regulations that can be purchased at modest prices. These editions are usually revised twice each year. For an annotated and abridged version of the Code and Regulations that is published annually, see James E. Smith, *South-Western Federal Taxation: Internal Revenue Code of 1986 and Treasury Regulations: Annotated and Selected* (Cengage/South-Western, 2011).

TAX in the NEWS

Internal Revenue Code: Interpretation Pitfalls

One author has noted 10 common pitfalls in interpreting the Code.

1. Determine the limitations and exceptions to a provision. Do not permit the language of the Code Section to carry greater or lesser weight than was intended.
2. Just because a Section fails to mention an item does not necessarily mean that the item is excluded.
3. Read definitional clauses carefully.
4. Do not overlook small words such as *and* and *or*. There is a world of difference between these two words.
5. Read the Code Section completely; do not jump to conclusions.
6. Watch out for cross-referenced and related provisions, since many Sections of the Code are interrelated.
7. At times Congress is not careful when reconciling new Code provisions with existing Sections. Conflicts among Sections, therefore, do arise.
8. Be alert for hidden definitions; terms in a particular Code Section may be defined in the same Section or in a separate Section.
9. Some answers may not be found in the Code; therefore, a researcher may have to consult the Regulations and/or judicial decisions.
10. Take careful note of measuring words such as *less than 50 percent, more than 50 percent,* and *at least 80 percent.*

Source: Adapted by permission from Henry G. Wong, "Ten Common Pitfalls in Reading the Internal Revenue Code," *Journal of Business Strategy*, July–August 1972, pp. 30–33. Reprinted with permission by Faulkner & Gray, Inc., 11 Penn Plaza, New York, NY 10001.

Interpreting the Internal Revenue Code

The language of the Code often is difficult to comprehend fully. Contrary to many people's suspicions, the Code is not written deliberately to confuse its readers. Nevertheless, it often has that effect. The Code is intended to apply to more than 300 million citizens, most of whom are willing to exploit any linguistic imprecision to their benefit—to find a "loophole," in popular parlance. Moreover, many of the Code's provisions are limitations or restrictions involving two or more variables. Expressing such concepts algebraically would be more direct; using words to accomplish this task instead is often quite cumbersome.

Nevertheless, the Code is the governing law, the only source of tax law (other than treaties) that has received the actual approval of Congress and the President. Accordingly, it is usually the first source to be consulted, and often it is the only source needed.

Assessing the Significance of a Treasury Regulation

Treasury Regulations are the official interpretation of the Code and are entitled to great deference. Occasionally, however, a court will invalidate a Regulation or a portion thereof on the grounds that the Regulation is contrary to the intent of Congress. Usually, courts do not question the validity of Regulations because of the belief that "the first administrative interpretation of a provision as it appears in a new act often expresses the general understanding of the times or the actual understanding of those who played an important part when the statute was drafted."[19]

Keep in mind the following observations when assessing the significance of a Regulation.

- IRS agents *must* give the Code and the Regulations issued thereunder equal weight when dealing with taxpayers and their representatives.
- Proposed Regulations provide a preview of future final Regulations, but they are not binding on the IRS or taxpayers.
- In a challenge, the burden of proof is on the taxpayer to show that a Regulation varies from the language of the statute and has no support in the Committee Reports.

[19] *Augustus v. Comm.*, 41–1 USTC ¶9255, 26 AFTR 612, 118 F.2d 38 (CA–6, 1941).

- Final Regulations can be classified as procedural, interpretive, or legislative. **Procedural Regulations** neither establish tax laws nor attempt to explain tax laws. Procedural Regulations often include procedural instructions, indicating information that taxpayers should provide the IRS, as well as information about the internal management and conduct of the IRS itself.
- **Interpretive Regulations** rephrase and elaborate what Congress stated in the Committee Reports that were issued when the tax legislation was enacted. Such Regulations are *hard and solid* and almost impossible to overturn unless they do not clearly reflect the intent of Congress.
- In some Code Sections, Congress has given the *Secretary or a delegate* the specific authority to prescribe Regulations to carry out the details of administration or to otherwise create rules not included in the Code. Under such circumstances, Congress effectively is delegating its legislative powers to the Treasury Department. Regulations issued pursuant to this type of authority possess the force and effect of law and often are called **Legislative Regulations** [e.g., see § 385(a)].

Assessing the Significance of Other Administrative Sources of the Tax Law

Revenue Rulings issued by the IRS carry much less weight than Treasury Department Regulations. Revenue Rulings are important, however, in that they reflect the position of the IRS on tax matters. In any dispute with the IRS on the interpretation of tax law, taxpayers should expect agents to follow the results reached in applicable Revenue Rulings. It is not unusual, however, for courts to overturn Revenue Rulings as incorrect applications of the law to the facts presented.

Actions on Decisions report the IRS's acquiescence or nonacquiescence to a published opinion. A nonacquiescence does not mean that a particular court decision is of no value, but it does indicate that the IRS may choose to litigate the issue involved.

Assessing the Significance of Judicial Sources of the Tax Law

The judicial process as it relates to the formulation of tax law has been described. How much reliance can be placed on a particular decision depends upon the following factors.

- *The level of the court.* A decision rendered by a trial court (e.g., a District Court) carries less weight than one issued by an appellate court (e.g., the Fifth Circuit Court of Appeals). Until Congress changes the Code, decisions by the U.S. Supreme Court represent the last word on any tax issue.
- *The legal residence of the taxpayer.* If, for example, a taxpayer lives in Texas, a decision of the Fifth Circuit Court of Appeals means more than one rendered by the Second Circuit Court of Appeals. This is the case because any appeal from a District Court or the Tax Court would be to the Fifth Circuit Court of Appeals and not to the Second Circuit Court of Appeals.
- *The type of decision.* A Tax Court Regular decision carries more weight than a Memorandum decision because the Tax Court does not consider Memorandum decisions to have precedential value.[20]
- *The weight of the decision.* A decision that is supported by cases from other courts carries more weight than a decision that is not supported by other cases.
- *Subsequent events.* Was the decision affirmed or overruled on appeal?

In connection with the last two factors, a citator is helpful to tax research.[21] A **citator** provides the history of a case, including the authority relied on (e.g., other judicial decisions) in reaching the result. Reviewing the references listed in the citator discloses whether the decision was appealed and, if so, with what result (e.g., affirmed, reversed, remanded). It also reveals other cases with the same or similar issues and how they were decided. Thus, a citator reflects on the validity of a case and may

[20] *Severino R. Nico, Jr.*, 67 T.C. 647 (1977).

[21] The major citators are published by Commerce Clearing House, RIA, WESTLAW, and Shepard's Citations, Inc.

TAX in the NEWS

Baseball and Tax Research

An analogy based on the philosophy of Sandy Koufax, a great pitcher for the Los Angeles Dodgers in the late 1950s and 1960s, may be appropriate for a tax researcher. Koufax is one of only some 17 baseball players to pitch a perfect game. He said that whenever he started a game, he tried to pitch a perfect game. If he was not successful, he tried for a no-hitter and then a shutout (no runs), and if he failed at all of these, he tried to win the game.

In researching a tax problem, the researcher tries first to find a Code Section, a tax treaty, or a committee report to support his or her position. If not successful in doing this, the researcher tries to find a Regulation, then a Revenue Ruling, and then a court decision (in this order). If no primary authority can be found, the researcher looks for a Bluebook passage, letter ruling, a learned book or article, or a comment from a tax service.

lead to other relevant judicial material. If one plans to rely on a judicial decision to any significant degree, "running" the case through a citator is imperative.

Understanding Judicial Opinions

Reading judicial opinions can be more productive if certain conventions of usage are understood. Some courts, including the Tax Court, apply the terms *petitioner* and *respondent* to the plaintiff and defendant, respectively, particularly when the case does not involve an appellate proceeding. Appellate courts often use the terms *appellant* and *appellee* instead.

It is also important to distinguish between a court's final determination, or *holding*, and passing comments made in the course of its opinion. These latter remarks, examples, and analogies, often collectively termed *dicta*, are not part of the court's conclusion and do not have precedential value. Nevertheless, they often facilitate one's understanding of the court's reasoning and can enable a tax adviser to better predict how the court might resolve some future tax case.

DIGGING DEEPER 4

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

Assessing the Significance of Other Sources

Primary sources of tax law include the Constitution, legislative history materials (e.g., Committee Reports), statutes, treaties, Treasury Regulations, IRS pronouncements, and judicial decisions. In general, the IRS regards only primary sources as substantial authority. However, reference to *secondary materials* such as legal periodicals, treatises, legal opinions, General Counsel Memoranda, and written determinations may be useful. In general, secondary sources are not authority.

Although the statement that the IRS regards only primary sources as substantial authority is generally true, there is one exception. Substantial authority *for purposes of* the accuracy-related penalty in § 6662 includes a number of secondary materials (e.g., letter rulings and General Counsel Memoranda).[22] "Authority" does not include conclusions reached in treatises, legal periodicals, and opinions rendered by tax professionals.

A letter ruling or determination letter can be relied upon *only* by the taxpayer to whom it is issued, except as noted above with respect to the accuracy-related penalty.

DIGGING DEEPER 5

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

[22]Reg. § 1.6661–3(b)(2).

ARRIVING AT THE SOLUTION OR AT ALTERNATIVE SOLUTIONS

Example 4 raises the question of whether taxpayers would be denied a loss deduction from the sale of stock to a corporation that they own. The solution depends, in part, on the relationship of the corporation's shareholders to each other. Since Fred and Megan are married to each other, § 267(c)(2) attributes Megan's stock to Fred in applying the "more than 50 percent" test of § 267(b)(2). Accordingly, Fred and Maple, Inc., are considered related parties under § 267(a), and a sale between them does not provide a deductible loss. If Fred and Megan were not related to each other, the constructive stock ownership rules would not apply, and a loss could be deducted on a sale by Fred to Maple.

If Maple, Inc., were a *partnership* instead of a corporation, § 267 would not apply.[23] That Regulation, however, references a different Code Section, namely § 707, which produces the same result: no deduction of the loss from a sale between a "more than 50 percent" partner and the partnership. This additional research prevents Fred and Megan from erroneously selling their Airways stock to a partnership in hopes of obtaining a loss deduction from the sale. Accordingly, Fred must sell the Airways stock to an unrelated party in order to deduct the loss.

Since Fred still wants to own Airways stock, he might consider purchasing new Airways Co. stock to replace the stock he sells. Additional research reveals that for the loss on the sale to be deductible, the "wash sale" rule requires that more than 30 days elapse between the purchase of the new stock and the sale of the old stock.[24] This rule applies to purchases and sales of *substantially identical stock or securities.* As a result, to deduct the loss on the Airways stock, Fred must either wait more than 30 days after selling this stock to buy new Airways stock or acquire stock in a different company at any time. This new company can even be in the same general business as is Airways.[25]

COMMUNICATING TAX RESEARCH

LO.3

Communicate the results of the tax research process in a client letter and a tax file memorandum.

Once the problem has been researched adequately, a memorandum, letter, or speech setting forth the result may need to be prepared. The form the communication takes could depend on a number of considerations. For example, does an employer or instructor recommend a particular procedure or format for tax research memos? Is the memo to be given directly to the client or will it first go to the preparer's employer? If the communication is a speech, who is the audience? How long should one speak?[26] Whatever form it takes, a good research communication should contain the following elements.

- A clear statement of the issue.
- In more complex situations, a short review of the fact pattern that raises the issue.
- A review of the pertinent tax law sources (e.g., Code, Regulations, Revenue Rulings, judicial authority).
- Any assumptions made in arriving at the solution.
- The solution recommended and the logic or reasoning supporting it.
- The references consulted in the research process.

A memo to the tax file is a collection of thoughts resulting from a current tax research project. It is shared with others who have access to the memo files so that they do not need to duplicate the current work at a later date. The file memo is written by a tax professional, to be read by another tax professional, so it features citations in good form to the Code, Regulations, and other sources of the law, often hyperlinking directly to the underlying document. A file memo is organized so as to list the pertinent facts, open tax issues, a brief conclusion, and a discussion of the research findings and underlying tax logic. A file memo seldom exceeds two pages in length.

[23]Reg. § 1.267(b)–1(b)(1).

[24]§ 1091.

[25]Rev.Rul. 59–44, 1959–1 C.B. 205.

[26]See W. A. Raabe and G. E. Whittenburg, "Talking Tax: How to Make a Tax Presentation," *The Tax Adviser*, March 1997, pp. 179–182.

FIGURE 2.6 Tax File Memorandum

August 26, 2010

TAX FILE MEMORANDUM

FROM Gillian J. Jones

SUBJECT Fred and Megan Taxpayer Engagement

Today I talked to Fred Taxpayer with respect to his August 14, 2010 letter requesting tax assistance. He wishes to know if he can sell his stock in Airways Co. to Maple, Inc., and deduct the $2,500 loss on his Airways stock.

FACTS Maple, Inc., is owned 50% by Fred and 50% by Megan. Fred wants to continue holding Airways stock in anticipation of a rebound in its value, and that is why he has asked about a proposed sale of this stock to Maple.

ISSUE Can shareholders deduct a loss on the sale of an asset to a corporation all of whose stock they own?

CONCLUSION Fred should *not* sell his Airways stock to Maple. Instead, he should sell this stock via his regular broker and either acquire new Airways stock more than 30 days before or after the date of sale, or acquire stock of a similar company.

ANALYSIS Section 267(a) provides that no loss will be deductible on a sale or exchange between certain related parties. One of these relationships involves a corporation and a shareholder who owns "more than 50 percent" of that corporation's stock [see § 267(b)(2)]. Although Fred owns only 50% of Maple, Inc., his wife, Megan, owns the other 50%. The constructive ownership rule of § 267(c)(2) attributes stock held by family members, and a spouse is part of a taxpayer's family for this purpose, according to § 267(c)(4). Consequently, Megan's stock will be attributed to Fred, who is then treated as owning 100% of Maple, Inc. The related-party disallowance rule would then apply to the loss from Fred's selling his Airways stock to Maple. Accordingly, Fred must sell this stock to an unrelated party to make his loss deductible.

Since Fred really wants to retain an investment in Airways, he can purchase replacement stock either before or after he sells his original Airways stock. Section 1091(a), however, requires that more than 30 days elapse between the purchase and the sale, or the sale and the purchase, as the case may be. Moreover, for this purpose, an option to buy the stock is treated as equivalent to the stock itself. As a result, Fred must wait more than 30 days between transactions and cannot utilize stock options in the interim to minimize his stock market exposure.

A final alternative might be to replace the Airways stock with securities of a comparable company in the same industry. Although no two companies are exactly alike, there may be another company whose management philosophy, marketing strategy, and financial data are sufficiently similar to Airways to provide an equivalent return on investment. Under this alternative, Fred could acquire the new company's shares immediately without waiting the 30 days mandated by § 1091(a). Despite the two companies' investment similarity, they would not be treated as "substantially identical" for this purpose [see Rev.Rul. 59–44, 1959–1 C.B. 205].

A letter to the client is written to convey the results of a research engagement, and to identify the next steps for the taxpayer to consider. Because most clients have little knowledge or experience in working with tax source documents, citations typically are not used. If the recipient of the letter is a tax executive or other colleague, a more technical approach might be taken in the letter. The letter typically does not exceed a page or two, and it sometimes is supplemented with an attached spreadsheet or chart. It includes various social graces and any needed regulatory language.

Illustrations of the memo for the tax file and the client letter associated with Example 4 appear in Figures 2.6 and 2.7.

FOLLOW-UP PROCEDURES

Because tax research may involve a proposed (as opposed to a completed) transaction, a change in the tax law (either legislative, administrative, or judicial) could alter the original conclusion. Additional research may be necessary to test the solution in light of current developments (refer to the broken lines at the right in Figure 2.5).

LO.4

Have an awareness of how best to use a computer when performing tax research and in taking the CPA exam.

COMPUTERS AND TAX RESEARCH

Computer-based tax research tools hold a prominent position in tax practice. Electronic tax resources allow the tax library to reflect the tax law's dynamic and daily changes. Nevertheless, using a computer to locate tax law sources cannot substitute

FIGURE 2.7 Client Letter

Smith, Raabe, and Maloney, CPAs
5191 Natorp Boulevard
Mason, OH 45040

August 30, 2010

Mr. and Ms. Fred Taxpayer
111 Tragg Boulevard
Williamsburg, Virginia 23185

Dear Fred and Megan:

It was good to see you last week at our firm's golf outing. I'm glad your children are doing so well in college, and that our work to build up their education funds was so effective in providing the needed cash flow!

I am responding to your request for us to review your family's financial and tax situation. Our conclusions are based upon the facts as outlined in your August 14th letter. Any change in the facts may affect our conclusions.

Fred owns stock in Airways Co. that has declined in value, but he would like to retain this stock in anticipation of a rebound in its value. You have proposed a sale of this stock at its current market value to Maple, Inc., a corporation owned 50–50 by the two of you. Such a sale, however, would not permit the loss to be deducted.

A better approach would be to sell the Airways stock before year-end and repurchase this stock through your regular stockbroker. Please understand that the loss will not be deductible unless more than 30 days elapse between the sale and the repurchase of the stock. You can either sell the old stock first and then buy the new stock, or buy the new stock first and then sell the old stock. However, it is essential that more than 30 days elapse between the sale and purchase transactions. Using options during this 30-day period is ineffective and will prevent the loss from being deducted in the current taxable year.

If the 30-day requirement is unacceptable, you might consider replacing the Airways stock with securities of some other company, perhaps even a company in the same general business as Airways. Your regular stockbroker should be able to suggest appropriate possibilities. In that situation, your loss on the Airways stock can be deducted without regard to when you buy the new stock.

Let's meet to discuss this some more, and so that I can show you our new office. Please e-mail me if I can clarify any of these points, or if you have more information for me to consider. My work on this engagement is regulated by Treasury Circular 230.

Sincerely yours,

Gillian J. Jones, CPA
Partner

for developing and maintaining a thorough knowledge of the tax law or for careful analysis when addressing tax research issues.

Most computerized services allow a user to retrieve documents in order of relevance, or in the order listed by database sources. Although this can be useful, just because a document is placed high on the relevance list does not mean it is valid law. Reading the primary sources, validating their authority, and checking the citator are essential in reaching a correct answer.

Using Electronic Tax Services

Usually, tax professionals use one of the following strategies when performing computer-based tax research.

- *Search* various databases using keywords that are likely to be found in the underlying documents, as written by Congress, the judiciary, or administrative sources.
- *Link* to tax documents for which all or part of the proper citation is known.
- *Browse* the tax databases, examining various tables of contents and indexes in a traditional manner or using cross-references in the documents to jump from one tax law source to another.

EXHIBIT 2.2 Online Commercial Tax Services

Online Service	Description
LEXIS/NEXIS	Includes Federal and state statutory, administrative, and judicial material. Extensive libraries of newspapers, magazines, patent records, and medical and economic databases, both U.S. and foreign-based.
RIA	Includes the RIA tax services, major tax treatises, Federal and state statutes, administrative documents, and court opinions. Extensive citator access, editorial material, and practitioner aids.
CCH	Includes the CCH tax service, primary sources including treatises, and other subscription materials. Tax and economic news sources, extensive editorial material, and practitioner support tools.
WESTLAW	Federal and state statutes, administrative documents, and court opinions. Extensive citator access, editorial material, and gateways to third-party publications. Extensive government document databases.

Virtually all of the major commercial tax publishers and most of the primary sources of the law itself, such as the Supreme Court and some of the Courts of Appeals, provide tax material in a variety of electronic formats.

Online Commercial Services

Online tax research systems allow practitioners to obtain virtually instantaneous use of tax law sources by accessing databases via the Internet. Online services may employ price-per-search cost structures, which can be as much as $200 per hour. Thus, unless a practitioner who is subject to this pricing structure can pass along related costs to clients or others, online searching generally is limited to the most important issues and to the researchers with the most experience and training in search techniques.

Exhibit 2.2 provides details about the most commonly used commercial online tax services.

The Internet

The Internet provides a wealth of tax information in several popular forms, sometimes at no direct cost to the researcher. Using web browser software and an Internet connection, the tax professional can access information provided around the world that can aid the research process.

- *The Web* provides access to a number of sites maintained by accounting and consulting firms, publishers, tax academics and libraries, and governmental bodies. The best sites offer links to other sites and direct contact to the site providers. Exhibit 2.3 lists some of the websites that may be most useful to tax researchers and their Internet addresses as of press date.
- *Blogs and newsletters* provide a means by which information related to the tax law can be exchanged among taxpayers, tax professionals, and others who subscribe to the group's services. The tax professional can read the exchanges among other members and offer replies and suggestions to inquiries as desired. Discussions address the interpretation and application of existing law, analysis of proposals and new pronouncements, and reviews of tax software.

EXHIBIT 2.3 Tax-Related Websites

Website	Web Address at Press Date	Description
Internal Revenue Service	**irs.gov**	News releases, downloadable forms and instructions, tables, Circular 230, and e-mail.
Court opinions	**lexisone.com/lx1/caselaw/freecaselaw**	Allows the researcher to link to the site of the jurisdiction (other than the Tax Court) that is the subject of the query.
Tax Analysts	**taxanalysts.com**	Policy-oriented readings on tax laws and proposals to change it, moderated bulletins on various tax subjects.
Tax Sites Directory	**taxsites.com**	References and links to tax sites on the Internet, including state and Federal tax sites, academic and professional pages, tax forms, and software.
Tax laws online	**cfr.law.cornell.edu/cfr**	Treasury Regulations.
	law.cornell.edu/uscode	Internal Revenue Code.
	uscode.house.gov/search/criteria.shtml	
Motley Fool Tax Page	**fool.com/taxes**	References and links to tax sites on the Internet.
Commercial tax publishers	For example, **cch.com**	Information about products and services available by subscription and newsletter excerpts.
Accounting firms and professional organizations	For example, the AICPA's page is at **aicpa.org**, Ernst & Young is at **ey.com**, and KPMG is at **kpmg.com**	Tax planning newsletters, descriptions of services offered and career opportunities, and exchange of data with clients and subscribers.

Caution: Addresses change frequently.

While tax information on the Internet is plentiful, public domain information never should be relied upon without referring to other, more reliable sources. Always remember that anyone can set up a website and quality control is often lacking.

In many situations, solutions to research problems benefit from, or require, the use of various electronic tax research tools. A competent tax professional must become familiar and proficient with these tools and be able to use them effectively, to meet the expectations of clients and the necessities of work in the modern world.[27]

2.3 Tax Research on the CPA Examination

The CPA examination is computer-based, and it emphasizes information technology and general business knowledge. The 14-hour exam has four sections, and taxation is included in the 3-hour Regulation section, which covers these topics.

- Federal tax procedures and accounting issues.
- Federal taxation of property transactions.
- Federal taxation—individuals.
- Federal taxation—entities.

Each exam section includes both multiple-choice questions and case studies called simulations. The multiple-choice part consists of three sequential "testlets," each containing 24 to 30 questions. These testlets are groups of questions prepared to appear together. In addition, each exam section includes a testlet, which consists of two simulations. A candidate may review and change answers within each testlet but cannot go back after exiting a testlet. Candidates take different, but equivalent exams.

[27]For a more detailed discussion of the use of electronic tax research in the modern tax practice, see W. A. Raabe, G. E. Whittenburg, and D. L. Sanders, *South-Western Federal Tax Research*, 8th ed. (Cengage Learning/South-Western, 2009).

TAX

An Electronic IRS

The IRS is pushing for greater numbers of taxpayers to file their tax returns electronically. For tax year 2008 over 80 million individuals filed their Forms 1040 using an electronic format. From the taxpayer's standpoint, electronic filing offers several advantages.

- Electronic filing better matches taxpayers' increasingly computer-oriented lifestyles. As many taxpayers use software to manage their bank and brokerage accounts, the transfer of tax data among programs becomes more effective.
- Refunds are processed and paid more quickly. Forty percent of returns receiving significant refunds and 75 percent of those using the earned income tax credit were e-filed. Nearly all of the e-filers chose to receive refunds by direct deposit.

The IRS benefits from electronic filing too.

- IRS computers capture all of the data submitted by an e-filing taxpayer, but only 40 percent from those filing returns on paper.
- The error rate for data entry into IRS computers is less than 1 percent for e-filed returns, but it is about 5 percent for paper-based returns.

Simulations are small case studies designed to test a candidate's tax knowledge and skills using real-life work-related situations. The simulations range from 30 to 50 minutes in length and complement the multiple-choice questions. Simulations include a four-function pop-up calculator, a blank spreadsheet with some elementary functionality, and authoritative literature for the candidate to research in completing the tax case study simulations (e.g., Internal Revenue Code and Federal tax forms). Examples of such simulations follow.

EXAMPLE 1

The tax *citation type* simulation requires the candidate to research the Internal Revenue Code and enter a Code Section and subsection citation. For example, Amber Company is considering using the simplified dollar-value method of pricing its inventory for purposes of the LIFO method that is available to certain small businesses. What Internal Revenue Code Section is the relevant authority to which you should turn to determine whether the taxpayer is eligible to use this method? To be successful, the candidate needs to find § 474. ■

EXAMPLE 2

A *tax form completion* simulation requires the candidate to fill out a portion of a tax form. For example, Green Company is a limited liability company (LLC) for tax purposes. Complete the income section of the Form 1065 for Green Company using the values found and calculated on previous tabs along with the following data.

Ordinary income from other partnerships	$ 5,200
Net gain (loss) from Form 4797	2,400
Management fee income	12,000

The candidate is provided with page 1 of Form 1065 on which to record the appropriate amounts. ■

Candidates can learn more about the CPA examination at **www.cpa-exam.org**. This online tutorial site reviews the exam's format, navigation functions, and tools. A 30- to 60-minute sample exam will familiarize a candidate with the types of questions on the examination.



Bridge to Regulation and Oversight

The interests of the public are represented by Federal, state, and local governments, as they oversee the various economic transactions carried out by individuals and businesses. Control of the financial sector is assigned to the Treasury and the Securities and Exchange Commission, among other agencies.

Most citizens assume that attorneys and CPAs hold broad, high-level skills in working with the tax laws. But the nature of today's economy dictates that professionals working in law and accounting instead develop narrower specialties that clients will find valuable in the marketplace. Only a subset of CPAs and attorneys practice regularly with the tax law, but all such professionals must hold and maintain broad-based skills in taxation.

Tax law is the subject of only one of the sections of the CPA exam, and only a portion of those questions relate to specific provisions of the tax law. The exam also tests the candidate's research and communication skills, and because it is administered with computer software, the candidate must have some technological facility as well.

The depth and variety of the skills that are required of an effective tax professional almost certainly are not measured well by the CPA or bar examinations. The integrity of the taxing system may be at risk when one can attain a credible professional certification with only entry-level skills. It is likely that several further levels of specialty certifications, and rigorous, lifelong skill improvement, should be required of tax professionals.

But because the CPA licensure process is controlled at the state level, it is unlikely that a coordinated effort to regulate the tax profession can be attained. A Federal level of such regulation is limited to the application of tax preparer penalties and the conduct directives of tax Regulations, such as that known as Circular 230. Given the complexity of the Federal tax law, and the growing number of taxpayers and tax practitioners, a more elaborate regulation process seems necessary to protect the public interest.

REFOCUS ON THE BIG PICTURE

RESEARCHING TAX QUESTIONS

Finding the various legislative, administrative, and judicial sources of tax law dealing with a specific issue and interpreting and assessing their relative importance is a difficult process. While Revenue Rulings are important in that they reflect the position of the IRS on specific tax issues, they do not carry as much weight as Treasury Department Regulations or the Internal Revenue Code. It is not unusual for a court to disagree with the findings of the IRS. However, the reliance that can be placed on the court decision depends on a number of factors, including the level of the court, the legal residence of the taxpayer, and the similarity of the case to the taxpayer's situation. An appellate court decision carries significant weight, particularly if it comes from the taxpayer's own circuit.

What If?

What if your research turns up a Tax Court case that supports the IRS's argument that the income is taxable? In this situation, the tax researcher should look carefully at the weight of the decision and any subsequent events that might have transpired. Is the decision supported by cases from other courts? Was the Tax Court decision appealed?

SUGGESTED READINGS

Sheldon I. Banoff and Richard M. Lipton, Editors' Shop Talk, "Is Wikipedia Good Authority in the Tax Court?" *Journal of Taxation*, April 2007.

Alexandra Defelice, "Tax Research Comes in Many Flavors," **www.webcpa.com/act_issues/2009_3/-31077-1.html**.

G. E. Whittenburg, M. Flatley, and W. A. Raabe, "Improving Accountants' Writing Skills," *National Public Accountant*, November 1998.

Kristie Wise, "The New Computer-Based CPA Exam Is a Success," **newaccountantusa.com/barneynewcpaexam.pdf**.

KEY TERMS

Acquiescence, 2–16
Circuit Court of Appeals, 2–13
Citator, 2–23
Court of Federal Claims, 2–11
Court of original jurisdiction, 2–11
Determination letters, 2–11
District Court, 2–11
Final Regulations, 2–9
Interpretive Regulations, 2–23
Legislative Regulations, 2–23
Letter rulings, 2–10
Nonacquiescence, 2–16
Precedents, 2–15
Procedural Regulations, 2–23
Proposed Regulations, 2–8
Revenue Procedures, 2–9
Revenue Rulings, 2–9
Small Cases Division, 2–11
Supreme Court, 2–15
Tax Court, 2–11
Technical Advice Memoranda (TAMs), 2–11
Temporary Regulations, 2–8
Writ of Certiorari, 2–15

PROBLEMS

1. **LO.1** What precedents must each of these courts follow?
   a. U.S. Tax Court.
   b. U.S. Court of Federal Claims.
   c. U.S. District Court.

COMMUNICATIONS

2. **LO.1, 3** Barbara Brown operates a small international firm named Mallard, Inc. A new treaty between the United States and Ukraine conflicts with a Section of the Internal Revenue Code. Barbara asks you for advice: If she follows the treaty position, does she need to disclose this on her tax return? If she is required to disclose, are there any penalties for failure to disclose? Prepare a letter in which you respond to Barbara. Mallard's address is 100 International Drive, Tampa, FL 33620.

3. **LO.1** What is the function of the Joint Conference Committee of the House Ways and Means Committee and the Senate Finance Committee?

4. **LO.1** Distinguish between the following.
   a. Treasury Regulations and Revenue Rulings.
   b. Revenue Rulings and Revenue Procedures.
   c. Revenue Rulings and letter rulings.
   d. Letter rulings and determination letters.

5. **LO.1, 2** Rank the following items from the highest authority to the lowest in the Federal tax law system.
   a. Interpretive Regulation.
   b. Legislative Regulation.
   c. Letter ruling.
   d. Revenue Ruling.
   e. Internal Revenue Code.
   f. Proposed Regulation.

6. **LO.1** Explain how Regulations are arranged. How would the following Regulations be cited?
   a. Final Regulations under § 132.
   b. Proposed Regulations under § 2036.
   c. Temporary Regulations under § 482.

7. **LO.1** Interpret each of the following citations.
   a. Prop.Reg. § 1.381(b)–1(a).
   b. Rev.Rul. 72–171, 1972–1 C.B. 208.
   c. TAM 200803017.

8. **LO.1** Which of the following would be considered advantages of the Small Cases Division of the Tax Court?
   a. Appeal to the Tax Court is possible.
   b. A hearing of a deficiency of $65,000 is considered on a timely basis.
   c. Taxpayer can handle the litigation without using a lawyer or certified public accountant.
   d. Taxpayer can use Small Cases Division decisions for precedential value.
   e. The actual hearing is conducted informally.
   f. Travel time will probably be reduced.

9. **LO.1** List an advantage and a disadvantage of using the U.S. District Court as the trial court for Federal tax litigation.

10. **LO.1, 3** Carl Jensen is considering litigating a tax deficiency of approximately $274,000 in the court system. He asks you to provide him with a short description of his alternatives indicating the advantages and disadvantages of each. Prepare your response to Carl in the form of a letter to him. His address is 200 Mesa Drive, Tucson, AZ 85714.

COMMUNICATIONS

11. **LO.1** A taxpayer lives in Michigan. In a controversy with the IRS, the taxpayer loses at the trial court level. Describe the appeal procedure for each of the following trial courts.
    a. Small Cases Division of the Tax Court.
    b. Tax Court.
    c. District Court.
    d. Court of Federal Claims.

12. **LO.1** Suppose the U.S. Government loses a tax case in the U.S. Tax Court and does not appeal the result. What does the failure to appeal signify?

13. **LO.1** For the Tax Court, District Court, and the Court of Federal Claims, indicate the following.
    a. Number of regular judges per court.
    b. Availability of a jury trial.
    c. Whether the deficiency must be paid before the trial.

14. **LO.1** In which of the following states could a taxpayer appeal the decision of a U.S. District Court to the Tenth Circuit Court of Appeals?
    a. Alaska.
    b. Arkansas.
    c. Florida.
    d. New York.
    e. Kansas.

15. **LO.1** What is meant by *stare decisis*?

CRITICAL THINKING

16. **LO.1, 2** In assessing the validity of a prior court decision, discuss the significance of the following on the taxpayer's issue.
    a. The decision was rendered by the U.S. District Court of Wyoming. Taxpayer lives in Wyoming.
    b. The decision was rendered by the Court of Federal Claims. Taxpayer lives in Wyoming.
    c. The decision was rendered by the Second Circuit Court of Appeals. Taxpayer lives in California.
    d. The decision was rendered by the Supreme Court.
    e. The decision was rendered by the Tax Court. The IRS has acquiesced in the result.
    f. Same as (e), except that the IRS has nonacquiesced in the result.

17. **LO.1** What is the difference between a Regular decision, a Memorandum decision, and a Summary Opinion of the Tax Court?

18. **LO.1** Interpret each of the following citations.
    a. 54 T.C. 1514 (1970).
    b. 408 F.2d 117 (CA–2, 1969).
    c. 69–1 USTC ¶9319 (CA–2, 1969).
    d. 23 AFTR 2d 69–1090 (CA–2, 1969).
    e. 293 F.Supp. 1129 (D.Ct. S.Miss., 1967).
    f. 67–1 USTC ¶9253 (D.Ct. S.Miss., 1967).
    g. 19 AFTR 2d 647 (D.Ct. S.Miss., 1967).
    h. 56 S.Ct. 289 (USSC, 1935).
    i. 36–1 USTC ¶9020 (USSC, 1935).
    j. 16 AFTR 1274 (USSC, 1935).
    k. 422 F.2d 1336 (Ct.Cls., 1970).

19. **LO.1** Explain the following abbreviations.

a.	CA–2	f.	*Cert. denied*	k.	F.3d
b.	Fed.Cl.	g.	*acq.*	l.	F.Supp.
c.	*aff'd.*	h.	B.T.A.	m.	USSC
d.	*rev'd.*	i.	USTC	n.	S.Ct.
e.	*rem'd.*	j.	AFTR	o.	D.Ct.

20. **LO.1** Which court issued each of these tax decisions?
    a. *Burton-Sutton Oil Co., Inc.*, 328 U.S. 25 (1946).
    b. *Rite Aid Corp.*, 85 AFTR 2d 2000–1439 (Fed.Cl., 2000), *rev'd*, 255 F.3d 1357, 88 AFTR 2d 2001–5058 (CA–F.C., 2001).
    c. *Herbert C. Hayes, Inc.*, T.C.Memo. 2004–185.
    d. *In re Continental Airlines*, 125 F.3d 120 (CA–3, 1997).
    e. *O'Neill v. Sears, Roebuck & Co.*, 108 F.Supp.2d 443 (D.Ct. Pa., 2000).
    f. Rev.Rul. 2009–15, 2009–21 I.R.B. 1035.

21. **LO.2** Where can you locate a published decision of the U.S. Court of Federal Claims?

22. **LO.2** Which of the following items can probably be found in the *Cumulative Bulletin*?
    a. Action on Decision.
    b. Small Cases Division of the Tax Court decision.
    c. Letter ruling.
    d. Revenue Procedure.
    e. Final Regulation.
    f. Court of Appeals decision.
    g. Senate Finance Committee Report.
    h. Acquiescences to Tax Court decisions.
    i. U.S. Circuit Court of Appeals decision.

23. **LO.2** Answer the following questions based upon this citation: *United Draperies, Inc. v. Comm.*, 340 F.2d 936 (CA–7, 1964), *aff'g* 41 T.C. 457 (1963), *cert. denied* 382 U.S. 813 (1965).
    a. In which court did this decision first appear?
    b. Did the appellate court uphold the trial court?
    c. Who was the plaintiff?
    d. Did the Supreme Court uphold the appellate court decision?

ISSUE ID

24. **LO.2, 4** Ashley is preparing a research paper discussing the tax aspects of alimony payments for her tax class. Explain to Ashley how she can research the provisions on this topic.

25. **LO.1, 2** Tom, an individual taxpayer, has been audited by the IRS and, as a result, has been assessed a substantial deficiency (which has not yet been paid) in additional income taxes. In preparing his defense, Tom advances the following possibilities.
    a. Although a resident of Kentucky, Tom plans to sue in a U.S. District Court in Oregon that appears to be more favorably inclined toward taxpayers.
    b. If (a) is not possible, Tom plans to take his case to a Kentucky state court where an uncle is the presiding judge.
    c. Since Tom has found a B.T.A. decision that seems to help his case, he plans to rely on it under alternative (a) or (b).
    d. If he loses at the trial court level, Tom plans to appeal either to the U.S. Court of Federal Claims or to the U.S. Second Circuit Court of Appeals because he has relatives in both Washington, D.C., and New York. Staying with these relatives could save Tom lodging expense while his appeal is being heard by the court selected.
    e. Whether or not Tom wins at the trial court or appeals court level, he feels certain of success on an appeal to the U.S. Supreme Court.

    Evaluate Tom's notions concerning the judicial process as it applies to Federal income tax controversies.

26. **LO.1** Using the legend provided, classify each of the following statements (more than one answer per statement may be appropriate).

Legend
D = Applies to the District Court
T = Applies to the Tax Court
C = Applies to the Court of Federal Claims
A = Applies to the Circuit Court of Appeals
U = Applies to the Supreme Court
N = Applies to none of the above

a. Decides only Federal tax matters.
b. Decisions are reported in the F.3d Series.
c. Decisions are reported in the USTCs.
d. Decisions are reported in the AFTRs.
e. Appeal is by *Writ of Certiorari.*
f. Court meets most often in Washington, D.C.
g. Offers the choice of a jury trial.
h. Is a trial court.
i. Is an appellate court.
j. Allows appeal to the Court of Appeals for the Federal Circuit, and bypasses the taxpayer's own Circuit Court of Appeals.
k. Has a Small Cases Division.
l. Is the only trial court where the taxpayer does not have to first pay the tax assessed by the IRS.

27. **LO.1, 2** Using the legend provided, classify each of the following citations as to the type of court.

Legend

D = District Court
T = Tax Court
C = Court of Federal Claims
A = Circuit Court of Appeals
U = Supreme Court
N = None of the above

a. Rev.Rul. 2009–34, 2009–42 I.R.B. 502.
b. *Joseph R. Bolker,* 81 T.C. 782 (1983).
c. *Magneson,* 753 F.2d 1490 (CA–9, 1985).
d. *Lucas v. Ox Fibre Brush Co.,* 281 U.S. 115 (1930).
e. *Ashtabula Bow Socket Co.,* 2 B.T.A. 306 (1925).
f. *BB&T Corp.,* 97 AFTR 2d 2006–873 (D.Ct. Mid.N.Car., 2006).
g. *Choate Construction Co.,* T.C.Memo. 1997–495.
h. Ltr.Rul. 200940021.
i. *John and Rochelle Ray,* T.C. Summary Opinion 2006–110.

28. **LO.1, 2** Using the legend provided, classify each of the following tax sources.

Legend

P = Primary tax source
S = Secondary tax source
B = Both
N = Neither

a. Sixteenth Amendment to the U.S. Constitution.
b. Tax treaty between the United States and France.
c. Revenue Procedure.
d. General Counsel Memoranda (issued 2009).
e. U.S. District Court decision.
f. *Tax Notes* article.
g. Temporary Regulations (issued 2008).
h. U.S. Tax Court Memorandum decision.
i. Small Cases Division of the U.S. Tax Court decision.
j. House Ways and Means Committee report.

29. **LO.2** An accountant friend of yours tells you that he "almost never" does any tax research, because he feels that "research usually reveals that some tax planning idea has already been thought up and shot down." Besides, he points out, most tax returns are never audited by the IRS. Can a tax adviser who is dedicated to reducing his client's tax liability justify the effort to engage in tax research? Do professional ethics *demand* such efforts? Which approach would a client probably prefer?

ETHICS AND EQUITY

ETHICS AND EQUITY

30. **LO.2** Another friend of yours, who is a philosophy major, has overheard the conversation described in the previous problem and declares that all tax research is "immoral." She says that tax research enables people with substantial assets to shift the burden of financing public expenditures to those who "get up every morning, go to work, play by the rules, and pay their bills." How do you respond?

31. **LO.4** In general, most tax research can now be conducted and conclusions reached with the use of materials available on the Internet. Assess the validity of this statement.

COMMUNICATIONS

32. **LO.4** Go to the U.S. Tax Court Internet site.
    a. What different types of cases can be found on the site?
    b. What is a Summary Opinion? Find one.
    c. What is a Memorandum Opinion? Find one.
    d. Find the "Rules and Practices and Procedures."
    e. Is the site user-friendly? E-mail suggested improvements to the site's webmaster.

CRITICAL THINKING

33. **LO.1, 3** Under what circumstances can court decisions lead to changes in the Code?

CRITICAL THINKING

COMMUNICATIONS

34. **LO.2, 3** Locate the following Code provisions and give a brief description of each in an e-mail to your instructor.
    a. § 61(a)(13).
    b. § 643(a)(2).
    c. § 2503(g)(2)(A).

Bridge DISCIPLINE

1. Comment on these statements.
    a. The tax law is created and administered in the same way as other Federal provisions.
    b. Most taxpayers find it too expensive and time-consuming to sue the government in a tax dispute.

COMMUNICATIONS

2. Using the title "The Federal Taxing System Operates outside the U.S. Constitution," write a two-page paper to submit in your Government Policy course. Do not address "tax protester" issues (e.g., that the income tax is unconstitutional or that one's taxes should be measured using only the gold standard). Instead, concentrate on how Federal tax law is made and interpreted, and how the process measures up to other governmental standards.

COMMUNICATIONS

3. Develop an outline from which you will deliver a 10-minute talk to the local Chamber of Commerce, with the title "Regulation of the Tax Profession in the 21st Century." Use no more than four PowerPoint slides for your talk, and discuss what the business community now needs with respect to oversight of a stable, yet productive, revenue-raising system.

RESEARCH PROBLEMS

THOMSON REUTERS
Checkpoint® Student Edition

Note: Solutions to Research Problems can be prepared by using the **Checkpoint® Student Edition** online research product, which is available to accompany this text. It is also possible to prepare solutions to the Research Problems by using tax research materials found in a standard tax library.

COMMUNICATIONS

Research Problem 1. Locate the following decision: *Dante and Sandi Peranso*, 130 T.C. ____, No. 8 (2008). In an e-mail to your instructor, indicate the following.
    a. Who was the petitioner?
    b. Who was the respondent?
    c. Who was the judge?
    d. What was the issue(s) for decision?
    e. What is Rule 122?
    f. What is Rule 155?
    g. What was the decision?
    h. Do capital expenditures reduce earnings and profits?
    i. Are organizational expenditures capital expenditures?

Research Problem 2. Locate the January 2009 issue of the *Journal of Taxation* and find the article by Richard M. Lipton. What are the title and page numbers of his article? What do DST and TRS stand for in the article?

Research Problem 3. Locate the following Code citations and give a brief topical description of each.

a. § 708(a).
b. § 1371(a).
c. § 2503(a).

Research Problem 4. Locate the following Regulations and give a brief topical description of each. Summarize your comments in an e-mail to your instructor.

COMMUNICATIONS

a. Reg. § 1.170A–4A(b)(2)(ii)(C).
b. Reg. § 1.672(b)–1.
c. Reg. § 20.2031–7(f).

Research Problem 5. Locate the following items and give a brief summary of each document.

a. Prop.Reg. § 1.864(b)–1(b)(2)(ii)(E).
b. Rev.Proc. 2005–50, I.R.B. No. 32, 272.
c. FSA 200228005.
d. § 32(c)(2)(A).
e. *Ramirez-Ota v. Comm.*, T.C. Summary Opinion, 2002–27.

Research Problem 6. Complete the following citations.

a. *Stubbs, Overbeck & Associates, Inc.*, 445 F.2d ___ (CA–5, 1971).
b. *Mead Corp.*, 533 U.S. 218 (___).
c. *Trinova Corp.*, 108 T.C. ___ (1997).
d. Notice 2003–___, 2003–1 C.B. 699.
e. *Linda Craven*, 215 F.3d 1201 (CA–11, ___).
f. *Anglo-American Direct Tea Trading Co.*, ___ B.T.A. 711 (1938).
g. *Nancy J. Vincent*, T.C. Memo. 2005– ___.
h. Rev.Rul. 75–28, 1975–___ C.B. 68.

Research Problem 7. Find *Kathryn Bernal*, 120 T.C. 102 (2003) and answer the following questions.

a. What was the docket number?
b. When was the dispute filed?
c. Who is the respondent?
d. Who was the attorney for the taxpayers?
e. Who was the judge who wrote the opinion?
f. What was the disposition of the dispute?

Research Problem 8. This year, Frank lived with and supported Daisy, an unrelated 20-year-old woman to whom he was not married. Frank lives in a state that has a statute that makes cohabitation a misdemeanor for a man and a woman who are not married to each other. May Frank claim Daisy as a dependent, assuming that he meets all of the applicable tests to claim the exemption? Should Frank and Daisy move to another state? Describe your research path in a PowerPoint presentation for your classmates.

DECISION MAKING

COMMUNICATIONS

Partial list of research aids:
§ 152(f)(3).
John T. Untermann, 38 T.C. 93 (1962).

Research Problem 9. When Oprah gave away Pontiac G6 sedans to her TV audience, was the value of the cars taxable? On Labor Day weekend in 2006, World Furniture Mall in Plano, Illinois, gave away $275,000 of furniture because the Chicago Bears shut out the Green Bay Packers in their football season opener at Lambeau Field in Green Bay (26–0). Was the free furniture in the form of a discount or rebate taxable, or should the furniture company issue the customers a Form 1099–MISC? Write a letter to your client, Maria Esposito (111 Hunt Wood Drive, Concord, NC 28025), summarizing your findings.

COMMUNICATIONS



Use the tax resources of the Internet to address the following questions. Do not restrict your search to the Web, but include a review of newsgroups and general reference materials, practitioner sites and resources, primary sources of the tax law, chat rooms and discussion groups, and other opportunities.

COMMUNICATIONS

Research Problem 10. Find tax research documents for the following on the Internet. Send one citation for each item to your instructor in an e-mail.

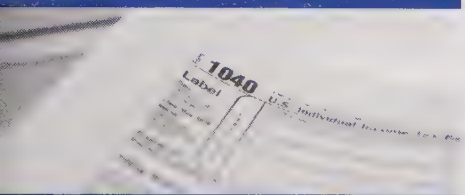
a. The U.S. Supreme Court, a Circuit Court of Appeals, the Internal Revenue Service, and final Regulations.
b. Sources of proposed Federal tax legislation.
c. A collection of tax rules for your state.

COMMUNICATIONS

Research Problem 11. Find three blogs related to tax practice. On one PowerPoint slide, list the URLs for each blog, and the general topical areas addressed at each. Send your slide to the others in your course.

CHAPTER 3

Taxes on the Financial Statements



TAX *Talk*

Truth is, figuring out how much tax a company actually pays is impossible.... Tax disclosure is just inscrutable.

—Robert Willens

LEARNING OBJECTIVES

After completing Chapter 3, you should be able to:

LO.1 Recognize the **differences between book and tax methods** of computing income tax expense. **(pp. 3-3 to 3-9)**

LO.2 Compute a corporation's **book income tax expense**. **(pp. 3-9 to 3-13)**

LO.3 Describe the purpose of the **valuation allowance**. **(pp. 3-13 to 3-16)**

LO.4 Recognize the **effect of ASC 740-30 (APB 23) on effective tax rates**. **(pp. 3-16 to 3-19)**

LO.5 Interpret the **disclosure information** contained in an income tax footnote. **(pp. 3-19 to 3-25)**

LO.6 Use financial statement income tax information to benchmark a company's tax position. **(pp. 3-26 to 3-29)**

OUTLINE

3.1 Book-Tax Differences, 3-3
Different Reporting Entities, 3-3
Different Taxes, 3-5
Different Methods, 3-5
3.2 Income Taxes in the Financial Statements, 3-9
GAAP Principles, 3-9
Valuation Allowance, 3-13
Earnings of Foreign Subsidiaries, 3-16
Tax Disclosures in the Financial Statements, 3-19
3.3 Benchmarking, 3-26

THE BIG PICTURE Tax Solutions for the Real World

TAXES ON THE FINANCIAL STATEMENTS

Raymond Jones, the CEO of Arctic Corporation, would like some help in reconciling the amount of income tax expense on Arctic's financial statements with the amount of income tax reported on the company's corporate income tax return for its first year of operations. Mr. Jones does not understand why he can't simply multiply the financial statement income by the company's 35 percent marginal tax rate to get the financial tax expense. While the financial statements show book income before tax of $25 million, the reported Federal tax expense is only $7.7 million. In addition, the corporate tax return reports taxable income of $19 million and Federal income taxes payable of only $6.65 million.

Without knowing the specifics of the company's financial statements, does Arctic's situation look reasonable? Why is Arctic's financial tax expense not equal to $8.75 million ($25 million × 35%)? What causes the $1.05 million difference between the taxes shown on the financial statements and the taxes due on the tax return? **Read the chapter and formulate your response.**

GlobalCo is a U.S. corporation with operations in 40 different states and 27 different countries. It pays income taxes in virtually all these jurisdictions. GlobalCo's investors and competitors are interested in understanding GlobalCo's effective tax rate. An examination of its financial statements indicates that GlobalCo has a 28 percent effective tax rate. How much of GlobalCo's tax expense is related to U.S. Federal tax, state and local tax, or taxes in foreign countries? What portion of its tax cost is currently paid versus deferred to some future period? Has GlobalCo recorded any deferred tax assets, representing future tax savings, or deferred tax liabilities, representing future tax costs? How does GlobalCo's effective tax rate for the current year compare to prior years, or to other companies in the same industry? Why is GlobalCo's effective tax rate not simply 35 percent, the statutory corporate rate for large U.S. corporations?

The bottom line result of the many tax planning ideas, advice, and compliance efforts provided by tax professionals to their clients is captured in a simple summary number—income tax expense. A U.S. corporation's tax expense is reported in its annual Federal tax return, its financial statements, and other regulatory filings and is often the starting point for state and local tax returns. As it turns out, however, deriving a corporation's income tax expense is not so simple.

A corporation may report millions of dollars in tax expense in its financial statements and yet pay virtually nothing to the U.S., state, or foreign governments. Alternatively, a corporation may pay substantial amounts to the U.S., state, and foreign governments and report very little income tax expense in its financial statements. Why do such differences exist? Which income tax expense is the "correct" number? How can data regarding a corporation's income tax expense provide valuable information for the corporation, its competitors, and tax professionals assisting in the planning function? This chapter addresses these questions.

TAX in the NEWS

HERE, THERE, AND EVERYWHERE—GLOBAL BUSINESS STRUCTURES

The collapse of Enron Corporation gave the public a peek behind the scenes of a multinational corporation's financial and tax strategies. It turned out that Enron used many sophisticated techniques—some legal and some not—to increase its reported net income and decrease its taxes.

Enron used so-called special purpose entities, structured so that the income or loss of the entities was not included in Enron's financial statements. Enron had over 900 subsidiaries located in a number of tax haven countries around the world. For example, Enron had 692 subsidiaries incorporated in the Cayman Islands, 119 subsidiaries in the Turks and Caicos Islands, and 43 subsidiaries in Mauritius.

The $50 billion investment Ponzi scheme carried out by Bernard Madoff over the last decade reportedly involved dozens of offshore entities. Global operations are important to meet the legitimate needs of U.S. businesses. However, offshore entities add complexity that can be used to obscure actual results.

3.1 BOOK-TAX DIFFERENCES

LO.1

Recognize the differences between book and tax methods of computing income tax expense.

A significant difference may exist between a corporation's Federal income tax liability as reported on its Form 1120 (tax) and the corporation's income tax expense as reported on its financial statements (book) prepared using **generally accepted accounting principles (GAAP)**. This book-tax difference is caused by any or all of the following.

- Differences in reporting entities included in the calculation.
- Different definition of taxes included in the income tax expense amount.
- Different accounting methods.

A corporation's activities are captured in its accounting records, producing general ledger results. At the end of the year, these records are summarized to produce a trial balance. Adjustments to these accounting data may be necessary to produce both the corporation's financial statements and its corporate income tax return. These adjustments rarely are the same. As discussed below, different entities may be included for different purposes, and the book and tax rules can be quite different. On a tax return, Schedule M–1 or M–3 reconciles the difference between a corporation's book income and its taxable income. See Figure 3.1.

DIFFERENT REPORTING ENTITIES

A corporate group must consolidate all U.S. and foreign subsidiaries within a single financial statement for book purposes when the parent corporation controls more than 50 percent of the voting power of those subsidiaries.[1] In cases where the parent corporation owns between 20 and 50 percent of another corporation, the parent uses the **equity method** to account for the earnings of the subsidiary. Under the equity method, the parent currently records its share of the subsidiary's income or loss for the year.[2] Corporations that own less than 20 percent of other corporations typically use the *cost method* to account for income from these investments and include income only when actual dividends are received.

EXAMPLE 2

Fisher, Inc., a domestic corporation, owns 100% of Gator, Inc., a domestic corporation; 100% of Hurricane, Ltd., a foreign corporation; and 40% of Beach, Inc., a domestic corporation. Fisher's combined financial statement includes its own net income and the net income of both Gator and Hurricane. In addition, Fisher's financial statement includes its 40% share of Beach's net income. Fisher's financial statement includes the

[1] *Consolidation*, ASC Topic 810 (formerly *Consolidation of All Majority Owned Subsidiaries*, Statement of Financial Accounting Standards No. 94). Certain adjustments are made to reduce book income for the after-tax income related to minority shareholders.

[2] *Investments—Equity Method and Joint Ventures*, ASC Topic 323 (formerly *The Equity Method of Accounting for Investments in Common Stock*, Accounting Principles Board Opinion No. 18).

TAX in the NEWS

A New Code?

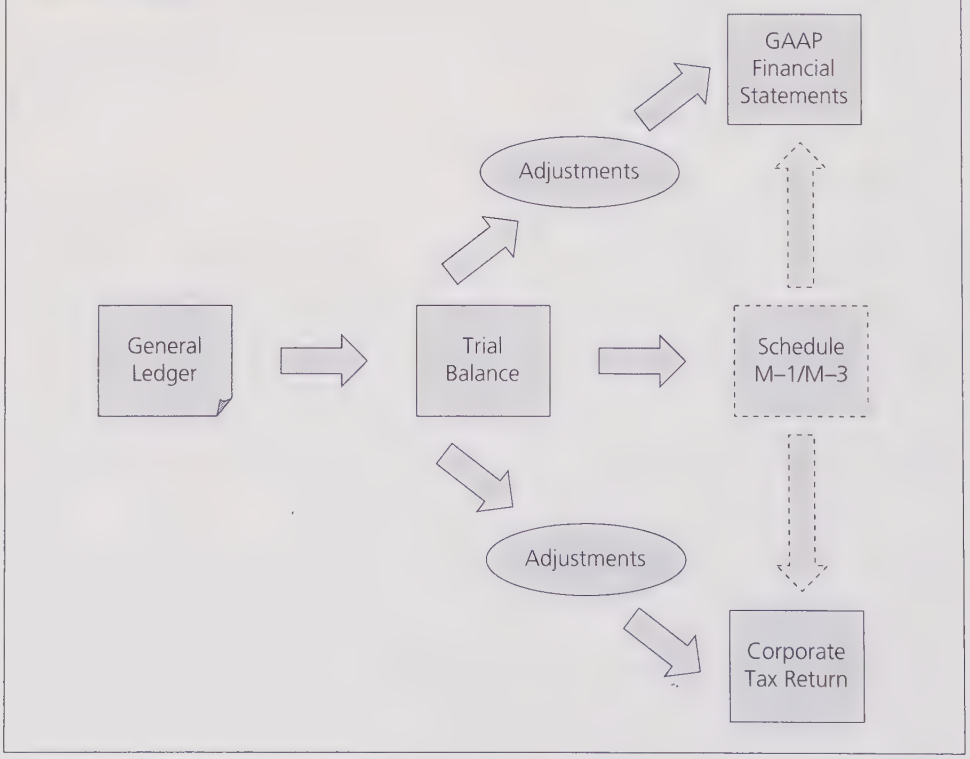
Tax practitioners long have referred to the Internal Revenue Code simply as the "Code." Now there's a new code (or codification) to deal with—the long-awaited codification (or reorganization) of all the existing accounting standards. In June 2009, the Financial Accounting Standards Board (FASB) issued *The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles—a replacement of FASB Statement No. 162,* Statement of Financial Accounting Standards No. 168. The FASB Accounting Standards Codification (ASC) is now the major source of authoritative U.S. accounting and reporting standards (for other than certain nongovernmental entities). Guidance will continue to be issued by the Securities and Exchange Commission. This change is effective for financial statements for interim or annual periods ending on or after September 15, 2009.

The Accounting Standards Codification has made a major change in the way that the authoritative accounting literature is organized and referenced. Accounting for income tax guidance formerly referenced as SFAS 109, or APB 23, or FIN 48, is now combined in ASC Topic 740. Novices and experts alike will have much to learn as they use and cite the new code.

income of these subsidiaries regardless of whether Fisher receives any actual profit distributions from its subsidiaries. ■

For Federal tax purposes, a U.S. corporation may elect to include any *domestic* subsidiaries that are 80 percent or more owned in its consolidated U.S. tax return.[3] The income of foreign subsidiaries and less than 80 percent owned domestic subsidiaries is not included in the consolidated tax return.

FIGURE 3.1 Flow of Accounting Data



[3] §§ 1501–1504. The election to consolidate an 80% or more owned subsidiary can be changed only with the permission of the IRS.

TAX in the News

To Deduct or Not to Deduct—The Question Is Answered

In March 2004, the Financial Accounting Standards Board proposed that companies be required to report the value of options they provide to their employees as an expense on their financial statements beginning in 2005. The International Accounting Standards Board adopted a similar rule effective in 2004. Some companies feared the effect this rule might have on their share prices, with the lower net income that stock option expensing would produce. High-tech companies were particularly concerned about this proposal because they are heavy users of stock options to attract employees.

The opponents of stock option expensing lobbied Congress to intervene with the FASB and prevent the adoption of this rule. This is not the first time the option-expensing controversy has erupted. The FASB almost adopted a similar rule in 1994 but backed down after intervention by the U.S. Senate and the Securities and Exchange Commission. However, the recent history of corporate failure and fraud, combined with the push for more transparency in financial statements, made Congress hesitant to get involved this time around.

Ultimately, the FASB issued *Compensation—Stock Compensation*, ASC Topic 718-10 (formerly, *Share-Based Payment*, Statement of Financial Accounting Standards No. 123R). The standard requires that the compensation cost relating to share-based payments be recognized as an expense in the income statement. The standard applies to many types of stock-based compensation, including stock options, restricted share plans, performance-based awards, share appreciation rights, and employee share purchase plans.

EXAMPLE 5

If Fisher from Example 1 elects to include Gator as part of its consolidated Federal income tax return, Fisher's return includes its own taxable income and the taxable income generated by Gator. Hurricane's taxable income is not included in the consolidated return because it is a non-U.S. corporation. Beach, although a domestic corporation, cannot be consolidated with Fisher because Fisher owns only 40% of the stock. Income from Hurricane and Beach will be included in Fisher's U.S. taxable income only when Fisher receives actual or constructive dividends. ■

DIFFERENT TAXES

The income tax expense reported on a corporation's financial statement is the combination of the entity's Federal, state, local, and foreign income taxes. This tax expense number includes both current and deferred tax expense amounts. The distinction between current and deferred income taxes is discussed later in this chapter.

EXAMPLE 6

For book purposes, Fisher, Gator, and Hurricane from Example 1 combine their income and expenses into a single financial statement. The book tax expense for the year includes all Federal, state, local, and foreign income taxes paid or accrued by these three corporations. In addition, the tax expense amount includes any future Federal, state, local, or foreign income tax expenses (or tax savings) on income reported in the current income statement. ■

The income tax expense computed on the Federal income tax return is the U.S. *Federal* income tax expense. This amount is based on the U.S. corporation's taxable income. State income taxes are reported on the Federal tax return, but as deductions in arriving at taxable income.

EXAMPLE 7

Fisher and Gator, from Example 1, file a consolidated Federal tax return. The tax expense reported on the Form 1120 is only the U.S. Federal income tax expense for the consolidated taxable income of Fisher and Gator. This tax expense does not include the income taxes that Fisher and its subsidiaries paid to state, local, or foreign governments. ■

TAX in the NEWS

Audit Roadmap Expands

The IRS audit roadmap now includes country lanes and alleyways instead of only major highways. Some U.S. corporations must disclose to the IRS much more detailed information about the differences between their book and taxable income. The book-tax reconciliation Schedule M–3 replaces the Schedule M–1 for consolidated tax groups with total year-end assets of $10 million or more. Schedule M–3 provides extensive detail on the differences between a corporation's book and taxable income, including information on entities included, income, and deductions.

The business community expressed concern over the compliance costs associated with providing this level of detail. These concerns did little to derail the expanded reporting requirements in an era of Sarbanes-Oxley, corporate fraud, and questions over whether corporations are paying their fair share of the tax burden.

DIFFERENT METHODS

Many differences exist between book and tax accounting methods. Some are simply **temporary differences**, with income and expenses appearing in both the financial statement and tax return, but in different periods (i.e., a timing difference). Others are **permanent differences**, with items appearing in the financial statement or the tax return, but not both.

Examples of temporary differences include the following.

- *Depreciation on fixed assets.* Taxpayers may use an accelerated depreciation method under the modified accelerated cost recovery system (MACRS) rules but a straight-line method for book purposes. Even if identical methods are used, the period over which the asset is depreciated may differ between book and tax.
- *Compensation-related expenses.* Several differences exist in this category. For example, under GAAP, corporations must accrue the future expenses related to providing postretirement benefits other than pensions (e.g., health insurance coverage). However, these expenses are deductible for tax purposes only when paid.
- *Accrued income and expenses.* Although most income and expense items are recognized for tax and book purposes in the same period, a number of items potentially appear in different periods. For example, warranty expenses are accrued for book purposes but are not deductible for tax purposes until incurred. Inventory write-offs are accrued for book but are not deductible for tax until incurred. On the income side, different methods regarding the timing of income recognition may create temporary differences.
- *Net operating losses.* Operating losses from one tax year may be used to offset taxable income in another tax year. Thus, the losses incurred in one year for book purposes may be used as a deduction for tax purposes in a different year.
- *Intangible assets.* Goodwill and some other intangibles are not amortizable for book purposes. However, GAAP requires an annual determination of whether the intangible has suffered a reduction in value (i.e., impairment).[4] If an intangible has suffered an impairment, a deduction is required to reduce the intangible's book value to the lower level. For tax purposes, certain post-1993 intangibles are amortized over 15 years.[5]

[4] *Intangibles—Goodwill and Other*, ASC Topic 350 (formerly *Goodwill and Other Intangible Assets*, Statement of Financial Accounting Standards No. 142).

[5] § 197. Note that prior to 1994, goodwill and similar intangibles were not amortizable for tax purposes but were amortizable for book purposes over a maximum period of 40 years. Thus, goodwill acquired during this period triggered a permanent difference (amortizable for book but not for tax).

FIGURE 3.2 Schedule M–1

Schedule M-1 **Reconciliation of Income (Loss) per Books With Income per Return**
Note: Schedule M-3 required instead of Schedule M-1 if total assets are $10 million or more—see instructions

1	Net income (loss) per books		7	Income recorded on books this year not included on this return (itemize):	
2	Federal income tax per books			Tax-exempt interest $	
3	Excess of capital losses over capital gains				
4	Income subject to tax not recorded on books this year (itemize):		8	Deductions on this return not charged against book income this year (itemize):	
5	Expenses recorded on books this year not deducted on this return (itemize):		a	Depreciation $	
a	Depreciation $		b	Charitable contributions $	
b	Charitable contributions $		9	Add lines 7 and 8	
c	Travel and entertainment $		10	Income (page 1, line 28)—line 6 less line 9	
6	Add lines 1 through 5				

Examples of permanent differences include the following.[6]

- *Nontaxable income.* A common example is municipal bond interest, which is income for book purposes but is not taxable.
- *Nondeductible expenses.* For example, the disallowed portion of meals and entertainment expense and certain penalties are not deductible for tax purposes but are expensed in arriving at book income.
- *Tax credits.* Credits such as the research activities credit reduce Federal income tax liability but have no corresponding book treatment.

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.



Wise, Inc., reported the following results for the current year.

Book income (before tax)	$ 685,000
Tax depreciation in excess of book	(125,000)
Nondeductible warranty expense	65,000
Municipal bond interest income	(35,000)
Taxable income (Form 1120)	$ 590,000

Wise reports net income before tax of $685,000 on its financial statement but must adjust this amount for differences between book and tax income. Tax depreciation in excess of book is a tax deduction not deducted for book purposes, and warranty expense is deductible for book purposes but not yet deductible for tax. Both these items are temporary differences because they will eventually reverse (with book depreciation eventually exceeding tax depreciation and the warranty expense ultimately deducted for tax when incurred). The municipal bond interest is a permanent difference because this income will never be subject to tax. ■

Figure 3.2 contains the **Schedule M–1** from Form 1120, the corporate income tax return. The purpose of Schedule M–1 is to reconcile book income to the taxable income reported on the tax return. Line 1 is the net income or loss per books, and

[6]Before the FASB changed the rules in 2004 for reporting stock options as an expense in financial statements, nonqualified stock option expenses also created a permanent difference because the corporation received a tax deduction on the date the employee exercised the option but was not required to deduct an expense for book purposes under prior GAAP. For an extended discussion of this issue, see M. Hanlon and T. Shevlin, "Accounting for Tax Benefits of Employee Stock Options and Implications for Research," *Accounting Horizons*, March 2002.

CONCEPT SUMMARY 3.1

Income Reporting: Book versus Tax

Financial Statement	U.S. Federal Income Tax Return
Reporting entities	**Reporting entities**
• 50% or more owned domestic and foreign subsidiaries *must* be consolidated.	• 80% or more owned domestic subsidiaries *may* be consolidated.
• Share of income from 20 to 50% owned domestic and foreign corporations included in current income.	• Share of income from other corporations reported only when actual or constructive dividends are received.
Income tax expense	**Income tax expense**
• Federal income taxes.	• Federal income taxes.
• State income taxes.	• Current only.
• Local income taxes.	
• Foreign income taxes.	
• Current and deferred.	
Methods	**Methods**
• Temporary differences.	• Temporary differences.
• Permanent differences.	• Permanent differences.
• Income tax note reconciliation.	• Schedule M–1 or M–3 reconciliation.

line 2 adds back the book tax expense in order to get back to book income before tax.[7] The remainder of Schedule M–1 contains positive and negative adjustments for both temporary and permanent differences until arriving at taxable income on line 10. For tax years after 2004, **Schedule M–3** is required for a consolidated tax group with total year-end assets of $10 million or more. Other corporations voluntarily may file a Schedule M–3. Appendix B of this text includes a copy of the Schedule M–3.

The income tax note of the financial statements also contains a tax reconciliation, but as discussed later, the purpose and content of this reconciliation are quite different. The book-tax differences reported on Schedule M–1 or M–3 relate to *current-year* differences in book income and taxable income. These items are related to the temporary and permanent differences that occur in determining a corporation's book tax expense. However, for book purposes, the temporary differences are the result of the *cumulative* changes in deferred tax assets and liabilities (as discussed later).

The Schedule M–3 provides the IRS with more detailed information than is provided in the Schedule M–1. A more specific "book income" starting point is used, with the taxpayer identifying the source of the book net income amount by answering a series of questions in Part I. Detail then is provided on differences due to the income or loss from foreign entities, along with data about eliminated intercompany transactions. The list of potential book-tax differences is significantly more comprehensive than that in the Schedule M–1, with income items reported in Part II and deduction items reported in Part III. And unlike the Schedule M–1, Schedule M–3 requires identification of whether a book-tax difference is temporary or permanent.

Schedule M–1 or M–3 is typically the starting point for IRS audits of corporations. Identifying large differences between book and taxable income may offer the IRS auditor insights into tax saving strategies (some perhaps questionable) employed by the taxpayer. Concept Summary 3.1 summarizes the book-tax differences in arriving at income tax expense.

[7] Line 1, "Net income (loss) per books," is not defined in the instructions to the form, and corporations seem to use various starting points in the Schedule M–1 (e.g., only the book income from U.S. members of the group). The Schedule M–3 expands the M–1 and provides much more detail and consistency.

TAX in the NEWS

The Book-Tax Income Gap

The corporate financial scandals of Enron, WorldCom, and others have heightened interest in whether corporations are making appropriate disclosures (i.e., transparency) and in whether they are shouldering their fair share of the tax burden. Adding fuel to the fire is the fact that the gap between book income and taxable income seems to be growing.

According to the Citizens for Tax Justice, 41 large companies reported over $28 billion in pretax book income but paid no U.S. taxes in at least one year between 1996 and 1998. An IRS study found that the aggregate difference between book and taxable income of active corporations increased by more than 70 percent between 1996 and 1998, with corporations reporting substantially more book income than taxable income during this period.

Congress and the U.S. Treasury are concerned about the increased efforts by corporations to reduce U.S. income tax obligations and issued regulations that require disclosure of certain "tax shelter" transactions. Corporations counter that the large differences in book and tax income are a function of the different rules and objectives of GAAP for financial statements and the Internal Revenue Code for tax returns.

3.2 Income Taxes in the Financial Statements

GAAP PRINCIPLES

LO.2

Compute a corporation's book income tax expense.

As pointed out earlier, a corporation's financial statements are prepared in accordance with GAAP. The purpose and objectives of these statements are quite different from the objective of the corporation's income tax return.

The **ASC 740 (SFAS 109)** approach produces a total income tax expense (also called the **income tax provision**) for the income currently reported on a corporation's combined financial statement.[8] This approach follows the matching principle, where all the expenses related to earning income are reported in the same period as the income without regard to when the expenses are actually paid.

PanCo, Inc., earns $100,000 in book income before tax. PanCo has a single temporary difference. Tax depreciation exceeds book depreciation by $20,000. Accordingly, PanCo's taxable income is $80,000 ($100,000 − $20,000 additional tax deduction). On its income tax return, PanCo reports total Federal tax expense of $28,000 ($80,000 × 35%). On its financial statement, PanCo reports a total tax expense of $35,000 ($100,000 × 35%). This $7,000 book-tax difference is the difference between the book and tax basis of the depreciable asset times the current corporate tax rate ($7,000 = $20,000 × 35%). Although PanCo did not actually pay the $7,000 this year, in future years when the book-tax depreciation difference reverses, the $7,000 eventually is paid. Hence, the *future* income tax expense related to the current book income is reported in the current year. ■

The total book tax expense under ASC 740 (SFAS 109) is made up of both current and deferred components.[9] The **current tax expense** theoretically represents the taxes actually payable to (or refund receivable from) the governmental authorities for the current period. Although an oversimplification, think of this amount as the actual check the taxpayer writes to the government (or refund received) for the current year. Keep in mind, though, that the current portion of the book income tax expense rarely matches the taxpayer's actual tax liability. Prior to 2005 a major cause of this disconnect was the tax deduction for employee stock options. The

[8] *Income Taxes*, ASC Topic 740 (formerly *Accounting for Income Taxes*, Statement of Financial Accounting Standards No. 109).

[9] Corporations also may include a "cushion" in their provision for income tax expense, to account in the current period for potential tax costs in the future (e.g., deficiencies related to losing a potential IRS audit). See ASC 740-10 (formerly *FASB Interpretation 48 [FIN 48], Accounting for Uncertainty in Income Taxes—An Interpretation of FASB Statement No. 109*, Financial Accounting Standards Board).

FIGURE 3.3 Current Tax Expense*

	Pretax book income
±	Schedule M–1/M–3 adjustments
	Taxable income before NOLs
–	NOL carryforwards
	Taxable income
×	Applicable tax rate
	Current tax expense (provision) before tax credits
–	Tax credits
	Current tax expense (tax provision)

*Simplified calculation.

corporation received a tax deduction at the date of employee exercise but was not required to deduct an expense for book purposes. Although this was a book-tax difference, it is not treated as a temporary or permanent difference in the ASC 740 (SFAS 109) calculation.[10] Numerous other items may lead to differences between actual current tax payments and the reported current tax expense. Figure 3.3 summarizes the computation of a corporation's current tax expense.

The deferred component of the book tax expense is called the **deferred tax expense** or **deferred tax benefit.** This component represents the future tax cost (or savings) connected with income reported in the current-period financial statement. Deferred tax expense or benefit is created as a result of temporary differences. More technically, ASC 740 (SFAS 109) adopts a **balance sheet approach** to measuring deferred taxes. Under this approach, the deferred tax expense or benefit is the change from one year to the next in the net **deferred tax liability** or **deferred tax asset.**

A deferred tax liability is the expected future tax liability related to current income (measured using enacted tax rates and rules).[11] A deferred tax liability is created in the following situations.

- An expense is deductible for tax in the current period but is not deductible for book until some future period.
- Income is includible currently for book purposes but is not includible in taxable income until a future period.

In essence, a deferred tax liability is created when the book basis of an asset exceeds its tax basis (the opposite results in a deferred tax asset).

EXAMPLE 3

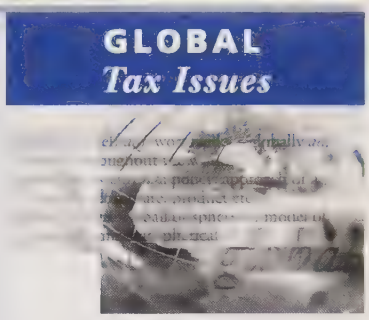
PJ Enterprises earns net income before depreciation of $500,000 in 2009 and $600,000 in 2010. Assume that PJ has a single depreciable asset acquired in 2009 for $80,000 and that for tax purposes PJ may deduct $60,000 in depreciation expense for the first year and $20,000 in depreciation expense for the second year (i.e., an accelerated method). For book purposes, assume that PJ depreciates the asset on a straight-line basis over two years ($40,000 depreciation expense per year).

2009

	Book	Tax
Income before depreciation	$500,000	$500,000
Depreciation	(40,000)	(60,000)
Income after depreciation	$460,000	$440,000
Corporate tax rate	× 35%	× 35%
Income tax expense	$161,000	$154,000

[10]See G. A. McGill and E. Outslay, "Did Enron Pay Taxes? Using Accounting Information to Decipher Tax Status," *Tax Notes*, August 19, 2002, for a discussion of issues surrounding the interpretation of the current tax payable account.

[11]If the tax rate will be different in future years, the *enacted* future tax rate should be used in the computation.



Accounting for Income Taxes in International Standards

The FASB and the International Accounting Standards Board (IASB) have worked to move the GAAP and IFRS treatment of income taxes closer together in light of the future convergence of GAAP and IFRS. Both ASC 740 (SFAS 109) and IAS 12 (the IFRS guidance for income taxes) are based on a balance sheet approach.

Nevertheless, several significant differences exist between the two standards. These include the thresholds for recognition and approach to valuation allowances, the treatment of foreign subsidiaries and undistributed earnings, and the measurement of uncertain tax positions.

One can keep up with the FASB and the IASB's work on the "Income Tax Project" by visiting the FASB website at **www.fasb.org** and searching for the "Current Technical Plan and Project Updates" section.

2009

	Book	Tax
Current tax expense	$154,000	
Deferred tax expense	$ 7,000	
Starting adjusted basis in depreciable asset	$ 80,000	$ 80,000
Ending adjusted basis in depreciable asset	(40,000)	(20,000)
Change in adjusted basis	$ 40,000	$ 60,000
Book-tax balance sheet difference	$20,000	
Corporate tax rate	× 35%	
Deferred tax liability	$ 7,000	

In this example, it is easy to "back into" the deferred tax expense amount of $7,000 by simply taking the difference between the tax expense per the tax return ($154,000) and the book tax expense ($161,000). This is referred to as the "APB 11" approach based on the method used before ASC 740 (SFAS 109). This may provide a quick check on the calculation in simple cases, but will not always be correct. The correct computation of the deferred tax expense is based on the difference between the book and tax asset basis numbers ($20,000) at the enacted corporate tax rate (35%).

2010

	Book	Tax
Income before depreciation	$600,000	$600,000
Depreciation	(40,000)	(20,000)
Income after depreciation	$560,000	$580,000
Corporate tax rate	× 35%	× 35%
Income tax expense	$196,000	$203,000
Current tax expense	$203,000	
Deferred tax expense	($ 7,000)	
Starting adjusted basis in depreciable asset	$ 40,000	$ 20,000
Ending adjusted basis in depreciable asset	(–0–)	(–0–)
Change in adjusted basis	$ 40,000	$ 20,000
Book-tax balance sheet difference	($20,000)	
Corporate tax rate	× 35%	
Deferred tax liability	($ 7,000)	

In 2010, the book-tax difference in asset basis reverses, with a resulting reverse in the deferred tax liability account. ■

EXAMPLE 8

Continue with the facts in Example 7. The following journal entries record the book tax expense (provision) for each year. Notice that the book total tax expense combines the current amount (income tax payable) and the future amount (deferred tax liability).

2009 journal entry		
Income tax expense (provision)	$161,000	
Income tax payable		$154,000
Deferred tax liability		7,000
2010 journal entry		
Income tax expense (provision)	$196,000	
Deferred tax liability	7,000	
Income tax payable		$203,000

At the end of 2009, the balance sheet reflects a net deferred tax liability of $7,000. At the end of 2010, the balance sheet contains no deferred tax liability because the temporary difference that created the deferred tax liability has reversed itself. ■

A deferred tax asset is the expected future tax benefit related to current book income (measured using enacted tax rates and rules). A deferred tax asset is created in the following situations.

- An expense is deductible for book in the current period but is not deductible for tax until some future period.
- Income is includible in taxable income currently but is not includible in book income until a future period.

EXAMPLE 9

MollCo, Inc., earns net income before warranty expense of $400,000 in 2009 and $450,000 in 2010. In 2009, MollCo deducts $30,000 in warranty expense for book purposes related to expected warranty repairs. This warranty expense is not deductible for tax purposes until actually incurred. Assume that the $30,000 warranty expense is paid in 2010 and that this is MollCo's only temporary difference.

2009	Book	Tax
Income before warranty expense	$400,000	$400,000
Warranty expense	(30,000)	—
Income after warranty expense	$370,000	$400,000
Corporate tax rate	× 35%	× 35%
Income tax expense	$129,500	$140,000
Current tax expense	$140,000	
Deferred tax expense	($ 10,500)	
Basis in warranty expense payable	$ 30,000	$ —0—
Book-tax balance sheet difference	($30,000)	
Corporate tax rate	× 35%	
Deferred tax asset	($10,500)	

In this example, it is easy to "back into" the deferred tax expense amount of $10,500 simply by taking the difference between the tax expense per the tax return ($140,000) and the book tax expense ($129,500). However, the correct computation of the deferred tax expense is based on the difference between the book and tax basis in the warranty expense payable ($30,000) at the corporate tax rate (35%).

2010

	Book	Tax
Income before warranty expense	$450,000	$450,000
Warranty expense	—	(30,000)
Income after depreciation	$450,000	$420,000
Corporate tax rate	× 35%	× 35%
Income tax expense	$157,500	$147,000
Current tax expense	$147,000	
Deferred tax expense	$ 10,500	
Basis in warranty expense payable	$ –0–	$ 30,000
Book-tax balance sheet difference	$30,000	
Corporate tax rate	× 35%	
Deferred tax asset	$10,500	

In 2010, the book-tax difference in warranty expense payable reverses, with a resulting elimination of the deferred tax asset account. ■

EXAMPLE 10

Continue with the facts in Example 9. The following journal entries record the book tax expense (provision) for each year. Notice that the book total tax expense combines the current amount (income tax payable) and the future amount (deferred tax asset).

2009 journal entry		
Income tax expense (provision)	$129,500	
Deferred tax asset	10,500	
Income tax payable		$140,000
2010 journal entry		
Income tax expense (provision)	$157,500	
Deferred tax asset		$ 10,500
Income tax payable		147,000

At the end of 2009, the balance sheet reflects a net deferred tax asset of $10,500. At the end of 2010, the balance sheet contains a zero deferred tax asset because the temporary difference that created the deferred tax asset has reversed. ■

Deferred tax assets and liabilities are reported on the balance sheet just as any other asset or liability would be. However, the interpretation of these assets and liabilities is quite different. Typically, an asset is "good" because it represents a claim on something of value, and a liability is "bad" because it represents a future claim against the corporation's assets. In the case of deferred tax assets and liabilities, the interpretation is reversed. Deferred tax liabilities are "good" because they represent an amount that may be paid to the government in the future. In essence, deferred tax liabilities are like an interest-free loan from the government with a due date perhaps many years in the future. Deferred tax assets, on the other hand, are future tax benefits and thus are similar to a receivable from the government that may not be received until many years in the future.

VALUATION ALLOWANCE

LO.3

Describe the purpose of the valuation allowance.

Much of GAAP is based on the **conservatism principle**. That is, accounting rules are designed to provide assurance that assets are not overstated and liabilities are not understated. Current recognition of deferred tax liabilities does not require significant professional judgment because future tax liabilities always are expected to be settled. However, under ASC 740 (SFAS 109), deferred tax assets are recognized only when it is probable that the future tax benefits will be realized.

EXAMPLE 11

Warren, Inc., reported book income before tax of $2 million in 2009. Warren's taxable income is also $2 million (no temporary or permanent differences). Warren has a current U.S. income tax liability for 2009 of $700,000 before tax credits ($2 million × 35%). During 2009, Warren paid $100,000 in foreign income taxes that it is not able to use as a credit on its 2009 tax return because of the foreign tax credit (FTC) limitation (see Chapter 13). Warren's auditors believe it is more likely than not that Warren will be able to use the $100,000 in FTCs within the next 10 years before they expire. Consequently, the future tax benefit of the FTCs is accounted for in the current-year book tax expense as a $100,000 future tax benefit.

The current and deferred tax expense are calculated as follows.

	Book	Tax
Income tax expense	$600,000	$700,000
Current tax expense	$700,000	
Deferred tax expense (benefit)	($100,000)	

Warren makes the following journal entry to record the book income tax expense and deferred tax asset related to the expected use of the FTCs.

Income tax expense (provision)	$600,000	
Deferred tax asset	100,000	
Income tax payable		$700,000

Because Warren is able to record the benefit of the future FTCs, its effective tax rate is 30% ($600,000 tax expense/$2 million book income before tax). ■

When a deferred tax asset does not meet the *more likely than not* threshold for recognition, ASC 740 (SFAS 109) requires that a **valuation allowance** be created. The valuation allowance is a contra-asset account that offsets all or a portion of the deferred tax asset.

EXAMPLE 12

Assume that the auditors in Example 11 believe that Warren will be able to use only $40,000 of the FTCs, with the remaining $60,000 expiring. In this case, the future tax benefit recognized currently should be only $40,000 rather than the full $100,000. To implement this reduction in the deferred tax asset, Warren must record a valuation allowance of $60,000, resulting in a book tax expense of $660,000.

	Book	Tax
Income tax expense	$660,000	$700,000
Current tax expense	$700,000	
Deferred tax expense (benefit)	($ 40,000)	

Warren makes the following journal entry to record the book income tax expense and deferred tax asset related to the expected use of the FTCs.

Income tax expense (provision)	$660,000	
Deferred tax asset	100,000	
Valuation allowance		$ 60,000
Income tax payable		700,000

Warren must reduce the deferred tax asset by $60,000, which increases its effective tax rate to 33% ($660,000 tax expense/$2 million book income before tax), compared with the 30% effective tax rate in Example 11. ■

To determine whether a valuation allowance is required, both positive and negative evidence must be evaluated. Examples of negative evidence (i.e., evidence suggesting that the deferred tax asset will not be realized) include the following.

- History of losses.
- Expected future losses.

TAX in the NEWS

Even Automaker Is Hurt by the Subprime Mortage Mess

General Motors took a $39 billion hit to earnings in the third quarter of 2007 by establishing a valuation allowance against certain deferred tax assets in the United States, Canada, and Germany. GM reported that one significant factor in creating the need for the valuation allowance was the problems related to its GMAC Financial Services Residential Capital mortgage business.

Although the increase in valuation allowance is not a cash-flow item, the $39 billion directly reduced GM's 2007 reported net income. Look for this item in GM's 2007 income tax footnote as a tax rate reconciling item. A hit to net income of $39 billion is a very large number, even for a company the size of GM. In comparison, GM's aggregate 2006 loss was only $2 billion. The reported losses of 2008 and 2009 likely triggered several major hits to valuation allowances for many companies.

Some observers believe that increases in valuation allowances are a harbinger of bad times to come for a company. This certainly turned out to be true for GM.

- Short carryback/carryforward periods.
- History of tax credits expiring unused.

Positive evidence (i.e., support for realizing the current benefit of future tax savings) includes the following.

- Strong earnings history.
- Existing contracts.
- Unrealized appreciation in assets.
- Sales backlog of profitable orders.

The valuation allowance is examined for appropriateness each year. The allowance may be increased or decreased if facts and circumstances change in the future.

Tax Planning Strategies

Releasing Valuation Allowances

FRAMEWORK FOCUS: DEDUCTIONS

Strategy: Maximize Deductible Amounts.

When a corporation records a valuation allowance, it loses the ability to recognize the benefit of future tax savings in the current period. However, all is not lost if the taxpayer can demonstrate that facts and circumstances have changed. For example, if a taxpayer generates a net operating loss (NOL), it records a deferred tax asset for the future tax savings related to using the NOL. However, if the evidence suggests that it is more likely than not that the NOL will expire unused, a valuation allowance must be recorded.

To reduce this valuation allowance, the taxpayer must demonstrate that there will be future taxable income sufficient to absorb the NOL within the carryforward period. Sources of future taxable income include reversals of temporary differences that will produce future taxable income and other sources of future profits. Taxpayers also may demonstrate that the adoption of new tax planning strategies will allow the use of deferred tax assets.

For example, assume that Warren, Inc., from Example 12, adopts new planning strategies in 2010 that will allow it ultimately to use all $100,000 of its FTC carryforward. Warren earns $2.3 million in book income before tax and reports $2.3 million in taxable income in 2010 (i.e., no permanent or temporary differences). The current tax expense is $805,000 ($2.3 million × 35%). Based on new evidence (implementation of tax planning strategies), the auditors determine that the entire $100,000 in FTCs will be used in the future before expiration. Accordingly, the $60,000 valuation allowance from 2009 is "released," and the tax benefit of this release affects the 2010 financial results as follows.

	Book	Tax
Income tax expense	$745,000	$805,000
Current tax expense	$805,000	
Deferred tax expense	($ 60,000)	

Warren makes the following journal entry to record the book income tax expense and valuation allowance release related to the expected use of the FTCs.

Income tax expense (provision)	$745,000	
Valuation allowance	60,000	
Income tax payable		$805,000

Warren's effective tax rate for 2010 is 32.4 percent ($745,000/$2.3 million). Without the valuation allowance release, Warren's effective tax rate would have been 35 percent ($805,000/$2.3 million). This tax rate benefit is realized even though the $100,000 in FTC carryforwards have yet to be actually used in Warren's tax return.



In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

LO.4

Recognize the effect of ASC 740-30(APB 23) on effective tax rates.

EARNINGS OF FOREIGN SUBSIDIARIES

As discussed earlier, a corporate group's financial statements include both domestic and foreign controlled subsidiaries. However, foreign corporations, even those controlled by U.S. shareholders, are not part of a U.S. consolidated tax return. Consequently, U.S. taxpayers can achieve deferral of current U.S. taxes on foreign income if they operate their foreign activities through foreign subsidiary corporations in jurisdictions with lower tax rates than the United States (see Chapter 13). Although the *actual* U.S. taxes on foreign corporations' profits are deferred, the reported effective tax rate for financial statement purposes may not reflect this deferral because ASC 740 (SFAS 109) requires that a corporate group report both current and deferred income tax expense.

EXAMPLE 11

USCo, a domestic corporation, operates a manufacturing facility in Singapore through a Singapore corporation. Assume that the U.S. tax rate is 35% and the Singapore tax rate is 6%. For the current year, USCo earns $600,000 in taxable income. The Singapore corporation earns $400,000 in taxable income from its operations, pays $24,000 in taxes to Singapore, and makes no distributions to its U.S. parent. The Singapore corporation is not taxed in the United States because it is not a U.S. person and has no activities in the United States.

USCo is not taxed on the Singapore profits because it has not received any distributions of these profits. Accordingly, USCo has achieved deferral and reduced its worldwide cash tax costs.

However, for financial statement purposes, the USCo group must include the $400,000 in Singapore profits in its net income and report both the Singapore tax and any *potential* U.S. tax (after allowable FTCs) as its total tax expense.

U.S. Tax Return		Potential U.S. Tax on Non-U.S. Income	
Income	$600,000	Income	$400,000
Tax rate	× 35%	Tax rate	× 35%
U.S. tax	$210,000	Total tax	$140,000
		Foreign tax credit	(24,000)
		Net U.S. tax	$116,000

Consequently, the total tax expense for financial statement purposes is $350,000. Keep in mind that the actual deferred tax liability is determined by multiplying the difference in the book and tax basis of the foreign subsidiary by the U.S. tax rate. There is a book-tax difference because the tax basis in the subsidiary is the original cost and the book basis has increased under the equity method of accounting by the equity in the subsidiary's earnings.



Bridge to Financial Accounting

Companies take positions in their tax returns that may not ultimately survive the scrutiny of the IRS or other tax authorities. If a taxpayer loses the benefit of a favorable tax position after a future audit, the loss of this tax benefit may unfavorably affect the company's financial statement tax expense in that future year. The additional tax cost will become part of the current tax expense, yet the income this tax is related to would have been reported in the initial year. This result wreaks havoc with a company's effective tax rate.

To avoid this increase in effective tax rate, companies may book a reserve or "cushion" for the uncertain tax position in the initial year. That is, rather than book the entire tax benefit (and thus reduce tax expense in the current year), the company may book only a portion (or none) of the tax benefit. If the company later loses the actual tax benefit upon audit, to the extent the additional tax imposed is charged against the reserve (or "cushion"), the additional tax does not affect the future-year tax expense. If the company's tax position is not challenged in the future (or the company successfully defends any challenge), the reserve can be released. This release reduces the current tax expense in the future (release) year and lowers the company's effective tax rate in that year.

Prior to 2006, *FAS 5, Accounting for Contingencies*, addressed the accounting for uncertain events in the financial statements. Some of the FAS 5 rules addressed the use of a required reserve related to taxes. Even with FAS 5, the FASB was concerned that companies too freely used the tax reserve as a "cookie jar" to shift earnings from one period to another. To add more structure to the accounting for tax reserves, in July 2006, the FASB released Financial Interpretation No. 48 (FIN 48), *Accounting for Uncertainty in Income Taxes*. This was the most significant change to the accounting for income taxes since the adoption of FAS 109. The approach required under ASC 740-10 (FIN 48) results in significantly more disclosure about uncertain tax positions by companies. This provision significantly changes the rules for accounting for uncertain tax positions.

Application of ASC 740-10 (FIN 48) essentially is a two-step process. First, a tax benefit from an uncertain tax position may be recognized in the financial statements only if it is more likely than not that the position would be sustained on its technical merits. That is, audit or detection risk cannot be considered. This first step determines whether *any* of the tax benefit is recognized. If the uncertain tax position meets the more likely than not threshold, the second step is to determine the amount of the tax benefit to report (i.e., the measurement step).

An uncertain tax position is measured as the largest amount that has a cumulative probability exceeding 50 percent of being the final outcome of the position. That is, the measurement is based on the probabilities associated with the position not being challenged, or being challenged with a negotiated settlement or litigation. All the relevant facts and circumstances as of the financial statement reporting date should be used in determining the probability of the ultimate outcome.

The recognition and measurement of uncertain tax positions must be reassessed at each reporting date. ASC 740-10 (FIN 48) requires a reconciliation of the beginning and ending balances of the unrecognized tax benefits and a discussion of potential changes in these unrecognized tax benefits that might occur over the next 12 months.

Current U.S. tax	$210,000
Current foreign tax	24,000
Deferred U.S. tax	116,000
Total tax expense	$350,000

The financial statement effective tax rate on USCo's global income is 35% ($350,000 total tax expense/$1,000,000 net income). Thus, although USCo paid only $234,000 in taxes, its effective tax rate (and thus its after-tax book income) does not reflect the savings generated from operating in Singapore, a low-tax country. ■

ASC 740-30 (APB 23) provides a special exception to ASC 740 (SFAS 109) for income from foreign subsidiaries.[12] If a corporation documents that it is **permanently reinvesting** the earnings of its foreign subsidiaries outside the United States, the corporation does not record as an expense any future U.S. income tax that the corporation may pay on such earnings.

[12]Formerly *Opinion No. 23—Accounting for Income Taxes—Special Areas*, Accounting Principles Board.

EXAMPLE 14

Assume that USCo, in Example 13, uses ASC 740-30 (APB 23) to avoid reporting the $116,000 in deferred taxes. Because USCo plans to reinvest its Singapore earnings indefinitely outside the United States, it is not required to include the deferred U.S. taxes as part of its total tax expense. Thus, USCo's total financial statement income remains $1 million, but its total tax expense is only $234,000 (the taxes currently paid to the United States and Singapore). The resulting financial statement effective tax rate is 23.4% ($234,000/$1,000,000), and the USCo group's after-tax book income reflects the Singapore tax savings. ■

Using ASC 740-30 (APB 23) is not an "all or nothing" decision. It can be adopted in some years and not others. Even within a year it may be used for only a portion of foreign subsidiary earnings.

EXAMPLE 15

Larson, Inc., a domestic corporation, has two wholly owned foreign subsidiaries, Arendt, Ltd., and Carroll, Ltd. Larson can choose to apply ASC 740-30 (APB 23) to both subsidiaries in 2008 and to only Arendt in 2009. In 2010, Larson can choose to use ASC 740-30 (APB 23) for 40% of Arendt's earnings and 80% of Carroll's earnings. ■

ASC 740-30 (APB 23) is only a major issue when the foreign subsidiary is taxed at rates below the U.S. tax rate. Otherwise, there is no deferral potential. However, using ASC 740-30 (APB 23) may limit the availability of creating deferred tax assets when foreign subsidiaries pay taxes at greater than the U.S. rate. Then the multinational group potentially could use these excess foreign taxes as credits on the U.S. tax return. See Chapter 13.

EXAMPLE 16

AmeriCo, a domestic corporation, operates a manufacturing facility in the Netherlands through a Dutch corporation. Assume that the U.S. tax rate is 35% and the Netherlands tax rate is also 35%. For the current year, AmeriCo earns $400,000 in taxable income. The Netherlands corporation earns $300,000 in taxable income from its operations, pays $105,000 in taxes to the Netherlands, and makes no distributions to its U.S. parent. The Netherlands corporation is not taxed in the United States because it is not a U.S. person and has no activities in the United States. AmeriCo is not taxed on the Netherlands profits because it has not received any distributions of these profits.

For financial statement purposes, the AmeriCo group must include the $300,000 in Dutch profits in its net income and report both the Dutch tax and any *potential* U.S. tax (after allowable FTCs) as its total tax expense.

U.S. Tax Return		Potential U.S. Tax on Foreign Income	
Income	$400,000	Income	$ 300,000
Tax rate	× 35%	Tax rate	× 35%
U.S. tax	$140,000	Total tax	$ 105,000
		FTC	(105,000)
		Net U.S. tax	$ –0–

Consequently, the total tax expense for financial statement purposes is $245,000.

Current U.S. tax	$140,000
Current foreign tax	105,000
Total tax expense	$245,000

The financial statement effective tax rate on global income is 35% ($245,000 total tax expense/$700,000 book net income). Even without ASC 740-30 (APB 23), there is no deferred U.S. tax on the Dutch income, because AmeriCo would pay no additional U.S. tax upon repatriation of the Netherlands earnings after its use of the available FTC.

An application of a valuation allowance against the deferred tax asset created by the FTC affects the book effective tax rate. ■

Tax Planning Strategies REDUCING EFFECTIVE TAX RATES WITH ASC 740-30 (APB 23) CAN BACKFIRE

FRAMEWORK FOCUS: DEDUCTIONS

Strategy: Maximize Deductible Amounts.

Because ASC 740-30 (APB 23) allows for higher reported book earnings (no deferred U.S. tax expense is recorded), its use may be reflected in higher stock prices and increased shareholder wealth. Although academic studies find mixed evidence on this effect, many U.S. multinationals with foreign subsidiaries do in fact use ASC 740-30 (APB 23) to avoid reporting U.S. deferred taxes on foreign earnings.

The "permanent reinvestment" exception should not be employed unless the corporation truly expects to keep its foreign earnings outside the United States. Using ASC 740-30 (APB 23) and then repatriating foreign profits after all can cause extreme spikes in a corporation's effective tax rate.

For example, USCo, a domestic corporation, owns 100 percent of Shamrock, Ltd., an Irish corporation. Assume that the U.S. tax rate is 35 percent and the Irish tax rate is 10 percent. In 2009, USCo earns $100,000 in taxable income and pays $35,000 to the United States. Shamrock earns $400,000 in taxable income and pays $40,000 in taxes to Ireland. Shamrock makes no distributions to its U.S. parent and is not taxed in the United States because it is not a U.S. person and has no activities in the United States.

USCo is not taxed on the Irish profits because it has not received any distributions of these profits. Furthermore, USCo uses ASC 740-30 (APB 23) to avoid recording any deferred U.S. income tax expense on its financial statements. Accordingly, USCo has achieved deferral and reduced its worldwide cash tax costs and book income tax expense.

USCo's total tax expense for financial statement purposes is $75,000.

Current U.S. tax	$35,000
Current foreign tax	40,000
Total tax expense	$75,000

The financial statement effective tax rate on USCo's global income is 15 percent ($75,000 total tax expense/$500,000 net income). Thus, the USCo group has achieved higher after-tax book income and earnings per share.

In 2010, USCo earns $200,000 in taxable income and pays $70,000 to the United States. Shamrock breaks even for the year and pays no taxes to Ireland. In 2010, USCo decides to have Shamrock pay it a dividend of $360,000.

U.S. Tax Return	
U.S. income	$200,000
Foreign dividend*	400,000
Taxable income	$600,000
Tax rate	× 35%
	$210,000
FTC	(40,000)
Net U.S. tax	$170,000

*The foreign dividend is the $360,000 cash dividend grossed up by the $40,000 potential FTC (see Chapter 13).

For book purposes, USCo reports only $200,000 in net income (the $400,000 in Irish income was included in book income in 2009 and is not included again). The 2010 total tax expense for financial statement purposes is $170,000.

Current U.S. tax	$170,000
Current foreign tax	—0—
Total tax expense	$170,000

The financial statement effective tax rate on USCo's global income is 85 percent ($170,000 total tax expense/$200,000 net income). This extremely high effective rate is caused by the mismatching of the Irish income (reported in 2009) and the U.S. taxes on the Irish income (reported in 2010).

TAX DISCLOSURES IN THE FINANCIAL STATEMENTS

LO.5

Interpret the disclosure information contained in an income tax footnote.

As illustrated earlier, any temporary differences create deferred tax liabilities or deferred tax assets, and these amounts appear in the corporation's balance sheet. As with any asset or liability, these accounts must be classified as either current or noncurrent, based on the assets or liabilities that created the temporary difference. If the deferred tax liability or asset is not related to any asset, then the classification is based on the expected reversal period.

JenCo, Inc., has a deferred tax liability generated because tax depreciation exceeds book depreciation on manufacturing equipment. Because the equipment is classified as a noncurrent asset, the deferred tax liability is classified as noncurrent. JenCo also has a

deferred tax asset related to bad debt expenses deductible for book purposes but not yet deductible for tax purposes. Because the bad debt expense is related to accounts receivable, a current asset, the associated deferred tax asset is classified as current.

If JenCo incurs an NOL, a deferred tax asset is created, because of the future tax benefit provided by the NOL deduction. The NOL is not related to any specific asset or liability. Accordingly, the deferred tax asset is classified based on when the corporation expects to use the NOL. If the expected use is more than one year in the future, the deferred tax asset is classified as noncurrent. ■

A corporation may have both deferred tax assets and liabilities, current and noncurrent. The corporation reports the *net* current deferred tax assets or liabilities, and the *net* noncurrent deferred tax assets or liabilities.

EXAMPLE 18

Jordan, Inc., has the following deferred tax asset and liability accounts for the current year.

Current deferred tax assets	$50,000
Current deferred tax liabilities	72,000
Noncurrent deferred tax assets	93,000
Noncurrent deferred tax liabilities	28,000

On its balance sheet, Jordan reports a $22,000 current net deferred tax liability ($72,000 – $50,000) and a $65,000 noncurrent net deferred tax asset ($93,000 – $28,000). ■

In its income statement, a corporation reports a total income tax expense that consists of both the current tax expense (or benefit) and the deferred tax expense (or benefit). The tax expense must be allocated to income from continuing operations, discontinued operations, extraordinary items, prior-period adjustments, and the cumulative effect of accounting changes. Additional disclosures are required for tax expense allocated to income from continuing operations (e.g., current versus deferred, benefits of NOL deductions, changes in valuation allowances, etc.).

The income tax note contains a wealth of information, including the following.

- Breakdown of income between domestic and foreign.
- Detailed analysis of the provision for income tax expense.
- Detailed analysis of deferred tax assets and liabilities.
- Effective tax **rate reconciliation** (dollar amount or percentage).
- Information on use of ASC 740-30 (APB 23) for the earnings of foreign subsidiaries.
- Discussion of significant tax matters.

The purpose of the rate reconciliation is to demonstrate how a corporation's actual book effective tax rate relates to its "hypothetical tax rate" as if the book income were taxed at the U.S. corporate rate of 35 percent. Although similar to Schedule M–1 or M–3, the tax note rate reconciliation generally reports only differences triggered by permanent differences. As discussed in the benchmarking section later in this chapter, an analysis of the rate reconciliation can provide substantial clues as to the tax planning strategies adopted (or not adopted) by a company.

The steps in determining a corporation's income tax expense for book purposes are summarized in Concept Summary 3.2.

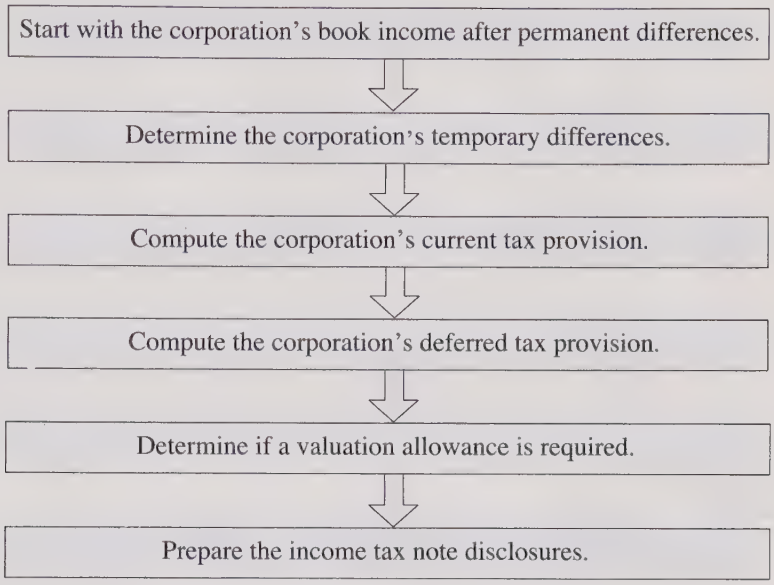
EXAMPLE 19

BoxCo, Inc., a domestic corporation, owns 100% of PaperCo, Ltd., an Irish corporation. Assume that the U.S. corporate tax rate is 35% and the Irish rate is 10%. BoxCo is permanently reinvesting PaperCo's earnings outside the United States under ASC 740-30 (APB 23). The corporations' book income, permanent and temporary differences, and current tax expense are as follows.



CONCEPT SUMMARY 3.2

Steps in Determining Book Tax Expense



	BoxCo	PaperCo
Book income before tax	$300,000	$200,000
Permanent differences		
Meals and entertainment expense	20,000	—
Municipal bond interest income	(50,000)	—
Book income after permanent differences	$270,000	$200,000
Temporary differences		
Tax > book depreciation	(50,000)	—
Book > tax bad debt expense	10,000	—
Taxable income	$230,000	$200,000
Tax rate	× 35%	× 10%
Current tax expense	$ 80,500	$ 20,000

Assume that the beginning-of-the-year difference between book and tax basis in the depreciable assets is $150,000 and the beginning-of-the-year difference between book and tax basis in the bad debt expense is $50,000. Thus, the beginning-of-the-year deferred tax liability is $35,000 [($150,000 − $50,000) × 35%]. To determine the deferred tax expense (benefit) for the current year, the change in these temporary differences from the beginning to the end of the year must be determined and then multiplied by the appropriate tax rate.

Temporary Differences	Beginning of Year	Change	End of Year
Depreciation	$150,000	$ 50,000	$200,000
Bad debts	(50,000)	(10,000)	(60,000)
Total temporary differences	$100,000	$ 40,000	$140,000
Tax rate	× 35%	× 35%	× 35%
	$ 35,000	$ 14,000	$ 49,000



Effective Tax Rates for Selected Fortune 100 Companies

The following table shows the provisions for income taxes made by selected major corporations, as a percentage of their book income before taxes.

General Electric	5.5%
Google	27.8
IBM	26.0
Citigroup	38.8
Ford	(0.4)
ExxonMobil	47.0
Wal-Mart	34.2
Chevron	44.3

Source: 2008 or 2009 10-K Filings with Securities and Exchange Commission.

The deferred tax liability increased by $14,000 for the year. Consequently, BoxCo's total tax expense for book purposes is $114,500.

Current tax expense	
Domestic	$ 80,500
Foreign	20,000
Deferred tax expense	
Domestic	14,000
Foreign	—
Total tax expense	$114,500

The journal entry to record the book income tax expense is constructed as follows.

Income tax expense (provision)	$114,500	
Income tax payable		$100,500
Deferred tax liability		14,000

BoxCo's book income is $500,000 (the combined book income of both BoxCo and PaperCo). The effective tax rate reconciliation is based on this book income, with the dollar amounts in the table representing the tax expense (benefit) related to the item, and the percentage representing the tax expense (benefit) as a percentage of book income. For example, the municipal bond interest of $50,000 reduces tax liability by $17,500 ($50,000 × 35%). This $17,500 as a percentage of the $500,000 book income is 3.5%.

	Effective Tax Rate Reconciliation	
	$	%
Hypothetical tax at U.S. rate	$175,000	35.0
Disallowed meals and entertainment expense	7,000	1.4
Municipal bond interest	(17,500)	(3.5)
Foreign income taxed at less than U.S. rate	(50,000)	(10.0)
Income tax expense (provision)	$114,500	22.9

Only permanent differences appear in the rate reconciliation. Temporary differences do not affect the *total* book income tax expense; they simply affect the amount of the tax expense that is current versus deferred. ■

EXAMPLE 20

Assume the same facts as Example 19, except that a new Federal income tax law is enacted before the end of the current year that will increase the corporate tax rate to 40% beginning next year. In this case, multiply the year-end total temporary differences of $140,000 by 40% rather than 35%. This results in an increase in the deferred tax liability of $21,000.

Temporary Differences	Beginning of Year	End of Year	Effect
Depreciation	$150,000	$200,000	
Bad debts	(50,000)	(60,000)	
Total temporary differences	$100,000	$140,000	
Tax rate	× 35%	× 40%	
Deferred tax liability	$ 35,000	$ 56,000	$21,000

The current-year deferred tax liability amount is a function of both the change in temporary differences at the enacted rate ($40,000 × 40%) and the additional 5% tax on the beginning temporary differences [$100,000 × (40% − 35%)]. This example illustrates the need for the "balance sheet" approach of ASC 740 (SFAS 109). Use of the APB 11 shortcut method would have produced the wrong answer with these facts. ■

EXAMPLE 21

LibbyCo, Inc., is a U.S. corporation that operates retail outlets selling eyeglasses. During the current year, LibbyCo reported pretax book income of $1,800. LibbyCo's U.S. corporate tax rate is 34%, it has no NOLs, credits, or foreign or state income taxes, and it is not subject to the alternative minimum tax.

LibbyCo's tax and book balance sheet is summarized below, along with book-tax basis differences for all assets and liabilities.

	Tax Debit/(Credit)	Book Debit/(Credit)	Difference
Assets			
Cash	$ 2,000	$ 2,000	$ –0–
Accounts receivable	5,400	5,400	–0–
Buildings	400,000	400,000	–0–
Accumulated depreciation	(315,000)	(330,000)	15,000
Furniture & fixtures	100,000	100,000	–0–
Accumulated depreciation	(70,000)	(45,000)	(25,000)
Total assets	$ 122,400	$ 132,400	($ 10,000)
Liabilities			
Accrued vacation pay	$ –0–	($ 25,000)	$ 25,000
Note payable	(16,400)	(16,400)	–0–
Total liabilities	($ 16,400)	($ 41,400)	$ 25,000
Stockholders' Equity			
Paid-in capital	($ 6,000)	($ 6,000)	
Retained earnings	(100,000)	(85,000)	
Total liabilities and stockholders' equity	($ 122,400)	($ 132,400)	

The difference between the book and tax basis of these assets and liabilities is the cumulative difference from all prior years. These differences are *not* the Schedule M–1 or M–3 differences. To determine the temporary differences for the current year and any associated deferred tax liability or deferred tax asset, these differences are compared to the basis differences at the beginning of the year.

Assume the following beginning-of-the-year book-tax differences. The end-of-the-year differences are calculated above. The differences are classified based on whether they produce a future tax benefit (deductible temporary differences) or a future tax cost (taxable temporary differences).

	Beginning of Year	Current-Year Difference	End of Year
Deductible Temporary Differences			
Buildings—accumulated depreciation	$ 10,000	$ 5,000	$ 15,000
Accrued vacation pay	17,000	8,000	25,000
Subtotal	$ 27,000	$13,000	$ 40,000
Applicable tax rate	× 34%		× 34%
Gross deferred tax asset	$ 9,180		$ 13,600
Change in deferred tax asset		$ 4,420	
Taxable Temporary Differences			
Furniture & fixtures—accumulated depreciation	($ 22,000)	($ 3,000)	($ 25,000)
Subtotal	($ 22,000)	($ 3,000)	($ 25,000)
Applicable tax rate	× 34%		× 34%
Gross deferred tax liability	($ 7,480)		($ 8,500)
Change in deferred tax liability		($ 1,020)	
Net deferred tax asset / (deferred tax liability)	$ 1,700	$ 3,400	$ 5,100

The journal entry to record the deferred tax asset is constructed as follows.

Deferred tax asset	$3,400	
Income tax expense		$3,400

In addition to the temporary differences identified above, LibbyCo also reported two permanent differences between book and taxable income. It earned $1,400 in tax-exempt municipal bond interest, and it incurred $2,000 in nondeductible meals and entertainment expense. With this information, the current tax expense is determined as follows.

Pretax book income	$ 1,800
Book-tax adjustments	
Permanent items	
Tax-exempt income	(1,400)
Nondeductible meals and entertainment	2,000
Temporary differences	
Building depreciation	5,000
Accrued vacation pay	8,000
Furniture & fixtures depreciation	(3,000)
Taxable income	$12,400
Current tax expense (34%)	$ 4,216

The building depreciation for book purposes exceeds tax depreciation, the furniture and fixtures depreciation for tax purposes exceeds book depreciation, and the accrued vacation pay is deductible for book purposes but not yet deductible for tax. These current-year temporary differences, combined with the two permanent items, also constitute the Schedule M–3 differences.

The journal entry to record the current tax expense is constructed as follows.

Income tax expense	$4,216	
Current income tax payable		$4,216

Assuming that no valuation allowance is required, the effect of these entries on the income statement is as follows. The current-year change in the deferred tax asset allows the book tax expense to be reduced by $3,400, producing a total book tax expense of $816 ($4,216 – $3,400).

Net income before tax	$1,800
Provision for income tax expense	(816)
Net income after tax	$ 984

The income tax footnote rate reconciliation is presented as follows.

Tax on book income at statutory rate	$ 612	34.00%
Tax-exempt income	(476)	(26.44)%
Nondeductible meals and entertainment	680	37.77%
Provision for income tax expense	$ 816	45.33%

With these facts, the "back-of-the-envelope" APB 11 method below produces the same results as the ASC 740 (SFAS 109) method. Note that this would not be true had there been changes to LibbyCo's applicable tax rate from the prior year, or if a valuation allowance had been required.

Pretax book income	$ 1,800
Permanent items	
Tax-exempt income	(1,400)
Nondeductible meals and entertainment	2,000
Book equivalent to taxable income	$ 2,400
Statutory tax rate	× 34%
Total book tax expense	$ 816

■

Tax Planning Strategies TAX SAVINGS ARE NOT ALWAYS CREATED EQUAL

FRAMEWORK FOCUS: THINKING OUTSIDE THE FRAMEWORK

Many different types of tax planning strategies can produce tax savings. Yet, even when planning ideas produce identical current cash-flow effects, some ideas may have an edge. CEOs and CFOs of public companies are very focused on the bottom line—the company's net income after tax and related earnings per share. A CFO is likely just as interested in an idea's effect on the company's bottom line income as on the cash tax savings.

For example, consider two tax planning ideas that each produce $700,000 of current tax savings. The first idea generates its $700,000 in tax savings by increasing tax depreciation relative to book depreciation by $2 million ($700,000 = $2 million × 35%). The second idea produces research activities tax credits of $700,000, thus reducing current-year tax by $700,000.

Idea 1 produces its current tax savings via a temporary difference. Accordingly, the book tax expense will not reflect the $700,000 in tax savings. Instead, this $700,000 simply moves from the current tax category into the deferred tax category. Even if the book-tax difference is not expected to reverse in the next 30 years (effectively generating "permanent" savings), the book tax expense does not reflect this savings.

In contrast, idea 2 produces its current tax savings via a permanent difference. Thus, the book tax expense also declines by $700,000. This item is a reconciling item in the income tax note rate reconciliation.

3.3 BENCHMARKING

LO.6

Use financial statement income tax information to benchmark a company's tax position.

As the *outcome* of the taxpayer's activities combined with the tax professional's advice, the income tax expense amount may appear to be of little interest to anyone beyond the taxpayer that makes the payment and the government agencies that collect it. The tax year is over, the transactions completed, and the final costs tallied. Still, this historical tax information may prove very valuable. A company's income tax expense is one of the single largest expense items on its income statement, and understanding the components of this expense is a critical activity for the tax professional.

Consider a typical baseball game. Two teams meet, interact following a specific set of rules, and ultimately complete the game generating a final score. Of course, the final score is of immediate interest to the teams and the fans, but once the game is over, the score and associated statistics (runs, hits, errors) are relegated to the history books. Yet these statistics are still quite useful. A team coach may use the game statistics to evaluate the strengths and weaknesses of the players to assist in improving performance. Other teams in the league may use the statistics to develop strategies for upcoming games. Players can use the statistics to benchmark themselves against their own performance in prior games or against players in other teams. In short, there is a wealth of information in these historical data.

A taxpayer's reported income tax expense is likewise a valuable source of information for the company, its tax advisers, and its competitors. The reported information provides clues about a company's operational and tax planning strategies.

Companies may benchmark their tax situation to other years' results or to other companies within the same industry. The starting point for a **benchmarking** exercise is the data from the income tax note rate reconciliation.

Figure 3.4 shows the tax rate reconciliation information from the income tax notes of Sears Holding Corporation (Sears) and Wal-Mart Stores, Inc. (Wal-Mart). Both companies are listed on the New York Stock Exchange, are in the same industry, and operate both inside and outside the United States. Although the income and tax expense amounts of both companies are quite different in magnitude, the tax amounts are converted to percentage of income numbers for comparability purposes. In 2008, Sears had an effective tax rate that was 12 percentage points higher than Wal-Mart's rate. What factors created this difference? Rate reconciliation information can provide clues.

Sears had a higher effective tax rate because its state and local income tax burden is higher, and because it suffered a goodwill impairment (the goodwill write-off is not tax deductible). These increase items were offset by reductions caused by certain

FIGURE 3.4 Tax Rate Reconciliation for Sears and Wal-Mart

	Sears		Wal-Mart	
	2008	2007	2008	2007
Hypothetical tax (benefit) at U.S. Federal rate	35.0%	35.0%	35.0%	35.0%
State and local income taxes, net of Federal benefit	7.2	2.0	1.9	1.7
Tax credits	(6.3)	(0.4)		
Resolution of income tax matters	(6.8)	0.5		
Basis difference in domestic subsidiary	(30.2)	0.3		
Non-U.S. income taxed at different rates	(2.3)		(1.7)	(1.6)
Nondeductible goodwill	50.0			
Other	(0.4)	0.5	(1.0)	(1.0)
	46.2%	37.9%	34.2%	34.1%
Book income before tax (in millions)	$184.0	$1,452.0	$20,898.0	$20,158.0



Bridge to Financial Analysis

Financial analysts perform an important function for the capital markets in their detailed analyses of companies. The analyst combs through both the financial reports and other information about a company to produce an informed opinion on how a company is performing. Analysts' earnings forecasts often are an important metric to examine when making decisions about investing in companies.

An experienced financial analyst typically will have a good handle on interpreting financial statement information. However, even experienced analysts will often "punt" when it comes to interpreting the tax information contained in a financial statement, preferring to look at net income before taxes (or even EBITDA, earnings before interest, taxes, depreciation, and amortization). Lots of useful information about a company is contained in its tax footnote, and analysts might have an edge if they work at understanding the mysteries of taxes in the income statement.

basis differences in a domestic subsidiary, larger benefits from tax credits, and a larger benefit from a favorable resolution of tax matters.

When comparing effective tax rates, it is important to consider which components of the effective tax rate produce one-time effects. For example, for 2007, the effective tax rates of both companies were much more similar (Sears was only a little over 3 percentage points higher than Wal-Mart). In particular, without the large effects of nondeductible goodwill and the domestic subsidiary basis difference, Sears approaches the effective tax rate of Wal-Mart. Even Sears's relative state and local tax burden was closer to Wal-Mart in 2007. Consequently, it appears that there are no long-term structural differences in the tax burdens faced by the two companies. This is not surprising given that both companies are incorporated in the United States, are in the same industry, and operate in many of the same jurisdictions.

However, items such as the nondeductible goodwill difference do indicate that there may be potential fundamental differences in how Sears's management deals with growth via expansion rather than acquisitions. It is acquired goodwill rather than the home-grown sort that faces potential impairment. The Sears example shows that the results of past and current strategic decisions eventually may show up in the income tax footnote.

In addition to comparing effective tax rates, companies can compare levels of deferred tax assets and liabilities.

EXAMPLE 3-22

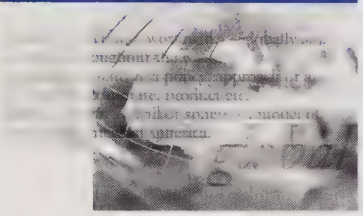
Akiko Enterprises reports a net deferred tax liability of $280,000. Asare, Inc., a company in the same industry, reports a net deferred tax liability of $860,000. Seeing deferred tax liabilities on the balance sheet indicates that these companies are both benefiting from deferring actual tax payments (essentially, an interest-free loan from the government). At first glance it may appear that Asare is doing better in this regard. However, what if Akiko holds total assets of $2.6 million and Asare's assets total $19.2 million? This information indicates that Akiko has 10.8% ($280,000/$2.6 million) of its total assets "financed" with an interest-free loan from the government, while Asare has only 4.5% ($860,000/$19.2 million) of its assets "financed" with its deferred tax liabilities. ■

A company may do a more refined benchmarking analysis by examining each component of its deferred tax assets and liabilities as a percentage of total assets. For example, a company can examine how the deferred tax assets or liabilities related to property, plant, and equipment compare with its competitors. The nature of the components of deferred tax liabilities and deferred tax assets becomes quite important in a benchmarking analysis.

EXAMPLE 3-23

LinCo reports total book income before taxes of $10 million and a total tax expense of $3.2 million, producing a 32% effective tax rate. TuckCo also reports book income before taxes of $10 million. TuckCo's total tax expense is $3.1 million, producing an

GLOBAL *Tax Issues*



International Accounting Standards on Their Way

The globalization of the economy has increased the need for a common language for financial reporting. Much of the world uses some variant of International Financial Reporting Standards (IFRS) as issued by the International Accounting Standards Board (IASB). The Securities and Exchange Commission (SEC) believes that a common approach to financial reporting is important, particularly so that U.S. investors can compare financial results across countries.

The SEC has issued a "roadmap" for the convergence of U.S. GAAP with IFRS. It provides several milestones that could lead to the use of IFRS by U.S. companies beginning as early as 2014. The roadmap provides that certain of the largest companies may elect to use IFRS beginning with filings for fiscal years ending on or after December 15, 2009.

The convergence of IFRS and GAAP will be the most significant change to accounting standards in the United States since the creation of the Financial Accounting Standards Board in 1972. Both preparers and users of financial statements have significant work to do to ready themselves for this transition.

The movement toward convergence seemed to slow in 2009. However, in a joint statement issued on November 5, 2009, the IASB and the FASB reaffirmed their commitment both to improve IFRS and GAAP and to bring about their convergence.

Source: Securities and Exchange Commission, 17 CFR Parts 210, 229, 230, 240, 244 and 249, [RELEASE NOS. 33-8982; 34-58960; File No. S7-27-08], November 14, 2008.

effective tax rate of 31%. At first glance it appears that both companies are similar with regard to effective tax rates. The total tax expense divided between current and deferred is as follows (in millions).

	LinCo	TuckCo
Current tax expense	$ 4.1	$ 4.2
Deferred tax benefit	(0.9)	(1.1)
Total tax expense	$ 3.2	$ 3.1

Again, it appears that both companies have created deferred tax assets in the current year that are expected to produce tax savings in the future. Knowing the nature of the underlying deferred tax assets will add greatly to the interpretation of the effective tax rates. The deferred tax asset generating LinCo's $900,000 expected future tax savings is the use of an NOL. The deferred tax asset generating TuckCo's expected future tax savings is generated by different book and tax methods in accounting for warranty expense. This additional information reveals that LinCo has previously incurred losses and it is critical that it earn future income in order to use the NOL.

This is quite different from TuckCo's situation, which reveals only that common differences in accounting methods exist. Although the tax positions of LinCo and TuckCo seem very similar on the surface, a closer look reveals a striking difference. ■

EXAMPLE 7A

WageCo and SalaryCo are both in the same industry and both report a 38% effective tax rate. Their book income and current, deferred, and total tax expense were reported as:

	WageCo	SalaryCo
Book income before tax	$1,500,000	$2,300,000
Current tax expense	$ 980,000	$ 24,000
Deferred tax expense (benefit)	(410,000)	850,000
Total tax expense	$ 570,000	$ 874,000
Effective tax rate	38%	38%

WageCo's total tax expense is highly dependent on the current recognition of future tax savings of $410,000. SalaryCo appears to be deferring a substantial portion of its tax expense to future years. Although both companies report a 38% effective tax rate, the details indicate that the two companies face very different tax situations. ■

It is important in benchmarking exercises to remove the effect of one-time items in comparing sustainable effective tax rates across time or companies. Examples of one-time items include restructuring costs, legal settlements, and IRS settlements. A one-time item may seem beneficial or detrimental to a company's effective tax rate. But the very nature of such an item implies that it has little to do with the company's long-term sustainable tax costs.

EXAMPLE 3-5

MetalCo and IronCo are both in the same industry and report the following tax rate reconciliations in their tax footnotes.

	MetalCo	IronCo
Hypothetical tax at U.S. rate	35.0%	35.0%
State and local taxes	2.2	2.1
Foreign income taxed at less than U.S. rate	(6.2)	(6.1)
Tax Court settlement on disputed tax issue	(18.6)	—
Effective tax rate	12.4%	31.0%

Although it appears that MetalCo has a significantly lower effective tax rate (12.4%) than IronCo's 31%, removing MetalCo's one-time item related to the court settlement indicates that both companies have a 31% effective tax rate (12.4% + 18.6% = 31%). ■

Benchmarking is part science and part art. A useful analysis requires both knowledge of how the underlying financial statements are constructed, including arriving at tax expense, and a detective's sense of where to look and what questions to ask.

REFOCUS ON THE BIG PICTURE

Raymond Jones should understand that the tax expense reported on the company's financial statements and the tax payable on the company's income tax returns are often different as a result of differences in the reporting entities used in the calculation and the different accounting methods used for book purposes and tax purposes. The use of different accounting methods may result in both temporary and permanent differences in financial statement income and taxable income. Examples of permanent differences include nontaxable income like municipal bond interest and tax credits. Temporary differences include depreciation differences and other amounts that are affected by the timing of a deduction or inclusion but ultimately will result in the same amount being reflected in the financial statements and income tax returns.

Permanent differences such as municipal bond interest cause Arctic's book income to be greater than its taxable income. In calculating the tax expense shown on the financial statements, Arctic's book income must be adjusted for these permanent differences. This results in an effective tax rate for financial statement purposes (30.8 percent) that is below the top U.S. statutory corporate income tax rate of 35 percent.

In this case, Arctic's income tax expense of $7.7 million is higher than the current Federal income tax payable. This results from timing differences and creates a $1.05 million deferred tax liability that is reported on the company's balance sheet. Unlike other liabilities, deferred tax liabilities are "good" in the sense that they represent an amount that may be paid to the government in the future rather than today.

CONTINUED

What If?

Mr. Jones is concerned about a newspaper article that said that companies reporting less tax on their tax returns than on their financial statements were cheating the IRS. Is this an accurate assessment?

While differences in income taxes payable to the IRS and financial tax expense can result from aggressive and illegal tax shelters, differences also result from different methods of accounting that are required for financial statement reporting using generally accepted accounting principles (GAAP) and tax laws as enacted by Congress.

SUGGESTED READINGS

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L. K. Mills, K. Newberry, and W. B. Trautman, "Trends in Book-Tax Income and Balance Sheet Differences, *Tax Notes,* August 19, 2002.

KEY TERMS

ASC 740 (SFAS 109), 3–9
ASC 740-30 (APB 23), 3–17
Balance sheet approach, 3–10
Benchmarking, 3–26
Conservatism principle, 3–13
Current tax expense, 3–9
Deferred tax asset, 3–10
Deferred tax benefit, 3–10
Deferred tax expense, 3–10
Deferred tax liability, 3–10
Equity method, 3–3
Generally accepted accounting principles (GAAP), 3–3
Income tax provision, 3–9
Permanent differences, 3–6
Permanently reinvesting, 3–17
Rate reconciliation, 3–20
Schedule M–1, 3–7
Schedule M–3, 3–8
Temporary differences, 3–6
Valuation allowance, 3–14

PROBLEMS

ETHICS AND EQUITY

1. **LO.1** Evaluate the following statement: To avoid the appearance of tax evasion, a corporation's reported book and taxable income should be virtually identical in any given year.

2. **LO.1** USCo, a domestic corporation, owns 100% of ForCo, a foreign corporation, and SubCo, a domestic corporation. USCo also owns 35% of InvestCo, a domestic corporation. USCo receives no distributions from any of these corporations. Which of these entities' net income is included in USCo's income statement for current-year financial reporting purposes?

3. **LO.1** USCo, a domestic corporation, owns 100% of ForCo, a foreign corporation, and SubCo, a domestic corporation. USCo also owns 35% of InvestCo, a domestic corporation. USCo receives no distributions from any of these corporations. Which of these entities' taxable income is included in USCo's current-year Form 1120, U.S. income tax return? Assume USCo consolidates all eligible subsidiaries.

4. **LO.1** Sarah Carter, the CFO of Mac, Inc., notices that the tax expense reported on Mac's tax return differs from the tax expense reported on Mac's financial statement. Provide a letter to Sarah outlining why these two tax expense numbers differ. Mac's address is 482 Linden Road, Paris, KY 40362. **COMMUNICATIONS**

5. **LO.1** Temporary and permanent differences both cause taxable income to differ from book income. Describe how these two book-tax differences affect the gap between book and taxable income. **ISSUE ID**

6. **LO.1** Identify two temporary book-tax differences and two permanent differences.

7. **LO.1** Indicate whether the following items create temporary or permanent differences.
   a. Tax depreciation in excess of book depreciation.
   b. Book depreciation in excess of tax depreciation.
   c. Municipal bond interest income.
   d. Increase in the allowance for doubtful accounts.
   e. Disallowed meals and entertainment expense for tax purposes.
   f. Deduction for legal expenses expected to be incurred to settle a lawsuit.

8. **LO.2** Indicate whether the following temporary differences produce deferred tax assets or deferred tax liabilities (considered independently).
   a. Tax depreciation in excess of book depreciation.
   b. Book depreciation in excess of tax depreciation.
   c. Increase in the allowance for doubtful accounts.
   d. Deduction for legal expenses expected to be incurred to settle a lawsuit.
   e. A current-year NOL.
   f. Foreign tax credits that are not allowed in the current year because of the FTC limitation.

9. **LO.5** Indicate whether the following temporary differences produce current or noncurrent deferred tax assets or deferred tax liabilities (considered independently).
   a. Tax depreciation in excess of book depreciation.
   b. Book depreciation in excess of tax depreciation.
   c. Increase in the allowance for doubtful accounts.
   d. Deduction for legal expenses expected to be incurred to settle a lawsuit.
   e. A current-year NOL.

10. **LO.1** Evaluate the following statement: The purpose of the Schedule M–1 and Schedule M–3 is to report the book income tax expense to the IRS. (Hint: Focus on the primary reason the IRS wants to see this information.)

11. **LO.2** Idil, a stock analyst, wants to understand the income tax expense reported in financial statements. Briefly describe the objective of ASC 740 (SFAS 109) with regard to reporting income tax expense.

12. **LO.2** BellCo, Inc., earns pretax book net income of $500,000 in 2010. BellCo acquires a depreciable asset in 2010, and first-year tax depreciation exceeds book depreciation by $50,000. BellCo has no other temporary or permanent differences. Assuming the U.S. tax rate is 35%, compute BellCo's total income tax expense, current income tax expense, and deferred income tax expense.

13. **LO.2** Using the facts of Problem 12, determine the 2010 end-of-year balance in BellCo's deferred tax asset and deferred tax liability balance sheet accounts.

14. **LO.2** BellCo, in Problem 12, reports $600,000 of pretax book net income in 2011. BellCo's book depreciation exceeds tax depreciation in this year by $20,000. BellCo has no other temporary or permanent differences. Assuming the U.S. tax rate is 35%, compute BellCo's total income tax expense, current income tax expense, and deferred income tax expense.

15. **LO.2** Using the facts of Problem 14, determine the 2011 end-of-year balance in BellCo's deferred tax asset and deferred tax liability balance sheet accounts.

16. **LO.2** Poco, Inc., earns pretax book net income of $250,000 in 2010. Poco deducted $30,000 in bad debt expense for book purposes. This expense is not yet deductible for tax purposes. Poco has no other temporary or permanent differences. Assuming the U.S. tax rate is 35%, compute Poco's total income tax expense, current income tax expense, and deferred income tax expense.

17. **LO.2** Using the facts of Problem 16, determine the 2010 end-of-year balance in Poco's deferred tax asset and deferred tax liability balance sheet accounts.

18. **LO.2** Poco, in Problem 16, reports $400,000 of pretax book net income in 2011. Poco did not deduct any bad debt expense for book purposes but did deduct $20,000 in bad debt expense for tax purposes. Poco has no other temporary or permanent differences. Assuming the U.S. tax rate is 35%, compute Poco's total income tax expense, current income tax expense, and deferred income tax expense.

19. **LO.2** Using the facts of Problem 18, determine the 2011 end-of-year balance in Poco's deferred tax asset and deferred tax liability balance sheet accounts.

20. **LO.3** Zoom, Inc., hopes to report a total book tax expense of $50,000 in the current year. This $50,000 expense consists of $80,000 in current tax expense and a $30,000 tax benefit related to the expected future use of an NOL by Zoom. If the auditors determine that a valuation allowance of $20,000 must be placed against Zoom's deferred tax assets, what is Zoom's total book tax expense?

21. **LO.3** Describe the factors considered in evaluating the need for a valuation allowance.

22. **LO.3** How does the release of a valuation allowance in a future year affect the book effective tax rate for that year?

DECISION MAKING

23. **LO.4** RadioCo, a domestic corporation, owns 100% of TVCo, a manufacturing facility in Ireland. TVCo has no operations or activities in the United States. The U.S. tax rate is 35%, and the Irish tax rate is 10%. For the current year, RadioCo earns $400,000 in taxable income. TVCo earns $800,000 in taxable income from its operations, pays $80,000 in taxes to Ireland, and makes no distributions to RadioCo. Determine RadioCo's effective tax rate for book purposes with and without the permanent reinvestment assumption of ASC 740-30 (APB 23). Under what conditions should RadioCo adopt ASC 740-30 (APB 23) for TVCo's earnings?

ISSUE ID

24. **LO.4** Shannon, the CFO of TechCo, Inc., has used ASC 740-30 (APB 23) to avoid reporting any U.S. deferred tax expense on $30 million of the earnings of TechCo's foreign subsidiaries. All of these subsidiaries operate in countries with lower tax rates than the United States. Shannon wants to bring home $10 million in profits from these foreign subsidiaries in the form of dividends. How will this profit repatriation affect TechCo's book effective tax rate?

ISSUE ID

25. **LO.4** Brian, the CFO of AutoCo, Inc., has used ASC 740-30 (APB 23) to avoid reporting any U.S. deferred tax expense on $60 million of the earnings of AutoCo's foreign subsidiaries. All of these subsidiaries operate in countries with higher tax rates than the ones that apply under U.S. law. Brian wants to bring home $20 million in profits from these foreign subsidiaries in the form of dividends. How will this profit repatriation affect AutoCo's book effective tax rate?

CRITICAL THINKING

26. **LO.1** Rufus Enterprises acquires another corporation. This acquisition created $10 million of goodwill for both book and tax purposes. The $10 million in goodwill is amortized over 15 years for tax purposes but is not deductible for book purposes unless impaired. Will this book-tax difference create a permanent or temporary difference?

DECISION MAKING

27. **LO.6** Lydia is the CFO of FarmTime, Inc. FarmTime's tax advisers have recommended two tax planning ideas that will each provide $8 million of current-year cash tax savings. One idea is based on a timing difference and is expected to reverse 20 years in the future. The other idea creates a permanent difference that will never reverse. Determine whether these ideas will allow FarmTime to reduce its reported book income tax expense for the current year. Illustrate your preference for one planning strategy over the other in a spreadsheet. Which idea will you recommend to Lydia?

COMMUNICATIONS

28. **LO.1, 5** Sam Taggart, the CEO of Skate, Inc., has reviewed Skate's tax return and its financial statement. He notices that both the Schedule M–3 and the rate reconciliation in the income tax note provide a reconciliation of tax information. However, he sees very little correspondence between the two schedules. Outline the differences between these two schedules in a letter to Sam. Skate's address is 499 Lucerne Avenue, Ocala, FL 34482.

29. **LO.6** RoofCo reports total book income before taxes of $20 million and a total tax expense of $8 million. FloorCo reports book income before taxes of $30 million and a

total tax expense of $12 million. The companies' breakdown between current and deferred tax expense (benefit) is as follows.

	RoofCo	FloorCo
Current tax expense	$ 8.2	$12.4
Deferred tax benefit	(0.2)	(0.4)
Total tax expense	$ 8.0	$12.0

RoofCo's deferred tax benefit is from a deferred tax asset created because of differences in depreciation methods for equipment. FloorCo's deferred tax benefit is created by the expected future use of an NOL. Compare and contrast these two companies' effective tax rates. How are they similar, and how are they different?

30. **LO.6** LawnCo and TreeCo operate in the same industry, and both report a 32% effective tax rate. Their book income and current, deferred, and total tax expense are reported below. **COMMUNICATIONS**

	LawnCo	TreeCo
Book income before tax	$ 500,000	$650,000
Current tax expense	$ 310,000	$ 17,000
Deferred tax expense (benefit)	(150,000)	191,000
Total tax expense	$ 160,000	$208,000
Effective tax rate	32%	32%

ShrubCo is a competitor of both these companies. Prepare a memo to Laura Collins, VP-Taxation, outlining your analysis of the two companies' effective tax rates, using only the information above.

31. **LO.6** RedCo and BlueCo operate in the same industry and report the following tax rate reconciliations in their tax footnotes.

	RedCo	BlueCo
Hypothetical tax at U.S. rate	35.0%	35.0%
State and local taxes	3.2	3.9
Foreign income taxed at less than U.S. rate	(12.3)	(7.8)
Tax Court settlement on disputed tax issue	5.3	—
Effective tax rate	31.2%	31.1%

Compare and contrast the effective tax rates of these two companies.

32. **LO.6** In 2009, Dickinson, Inc., reports an effective tax rate of 36%, and Badger, Inc., reports an effective tax rate of 21%. Both companies are domestic and operate in the same industry. Your initial examination of the financial statements of the two companies indicates that Badger apparently is doing a better job with its tax planning, explaining the difference in effective tax rates. Consequently, all else being equal, you decide to invest in Badger. **ETHICS AND EQUITY**

In a subsequent year, it comes to light that Badger had used some very aggressive tax planning techniques to reduce its reported tax expense. After examination by the IRS, Badger loses the tax benefits and reports a very large tax expense in that year. Over this multiple-year period, it turns out that Dickinson had the lower effective tax rate after all.

Do you believe Badger was ethical in not fully disclosing the aggressiveness of its tax positions in its 2009 financial statement? How does ASC 740-10 (FIN 48) affect Badger's disclosure requirement? Does ASC 740-10 (FIN 48) still leave room for ethical decision making by management in determining how to report uncertain tax positions?

33. **LO.2** Relix, Inc., is a domestic corporation with the following balance sheet for book and tax purposes at the end of the year. Based on this information, determine Relix's net deferred tax asset or net deferred tax liability at year end. Assume a 34% corporate tax rate and no valuation allowance.

	Tax Debit/(Credit)	Book Debit/(Credit)
Assets		
Cash	$ 500	$ 500
Accounts receivable	8,000	8,000
Buildings	750,000	750,000
Accumulated depreciation	(450,000)	(380,000)
Furniture & fixtures	70,000	70,000
Accumulated depreciation	(46,000)	(38,000)
Total assets	$332,500	$ 410,500
Liabilities		
Accrued litigation expense	$ –0–	($ 50,000)
Note payable	(78,000)	(78,000)
Total liabilities	($ 78,000)	($ 128,000)
Stockholders' Equity		
Paid-in capital	($ 10,000)	($ 10,000)
Retained earnings	(244,500)	(272,500)
Total liabilities and stockholders' equity	($332,500)	($ 410,500)

34. **LO.2** Based on the facts and results of Problem 33 and the beginning-of-the-year book-tax basis differences listed below, determine the change in Relix's deferred tax assets for the current year.

	Beginning of Year
Accrued litigation expense	$34,000
Subtotal	$34,000
Applicable tax rate	× 34%
Gross deferred tax asset	$11,560

35. **LO.2** Based on the facts and results of Problem 33 and the beginning-of-the-year book-tax basis differences listed below, determine the change in Relix's deferred tax liabilities for the current year.

	Beginning of Year
Building—accumulated depreciation	($57,000)
Furniture & fixtures—accumulated depreciation	(4,200)
Subtotal	($61,200)
Applicable tax rate	× 34%
Gross deferred tax liability	($20,808)

36. **LO.2** Based on the facts and results of Problems 33–35, determine Relix's change in net deferred tax asset or net deferred tax liability for the current year and provide the journal entry to record this amount.

37. **LO.2** In addition to the temporary differences identified in Problems 33–36, Relix, Inc. reported two permanent differences between book and taxable income. It earned $2,375 in tax-exempt municipal bond interest, and it incurred $780 in nondeductible meals and entertainment expense. Relix's book income before tax is $4,800. With this additional information, calculate Relix's current tax expense.

38. **LO.2** Provide the journal entry to record Relix's current tax expense as determined in Problem 37.

39. **LO.2** Based on the facts and results of Problems 33–38, calculate Relix's total provision for income tax expense reported in its financial statements and its book net income after tax.

40. **LO.2** Based on the facts and results of Problems 33–39, provide the income tax footnote rate reconciliation for Relix.

41. **LO.2** Kantner, Inc., is a domestic corporation with the following balance sheet for book and tax purposes at the end of the year. Based on this information, determine Kantner's net deferred tax asset or net deferred tax liability at year-end. Assume a 34% corporate tax rate and no valuation allowance.

	Tax Debit/(Credit)	Book Debit/(Credit)
Assets		
Cash	$ 1,000	$ 1,000
Accounts receivable	9,000	9,000
Buildings	850,000	850,000
Accumulated depreciation	(700,000)	(620,000)
Furniture & fixtures	40,000	40,000
Accumulated depreciation	(10,000)	(8,000)
Total assets	$ 190,000	$ 272,000
Liabilities		
Accrued warranty expense	$ –0–	($ 40,000)
Note payable	(16,000)	(16,000)
Total liabilities	($ 16,000)	($ 56,000)
Stockholders' Equity		
Paid-in capital	($ 50,000)	($ 50,000)
Retained earnings	(124,000)	(166,000)
Total liabilities and stockholders' equity	($ 190,000)	($ 272,000)

42. **LO.2** Based on the facts and results of Problem 41 and the beginning-of-the-year book-tax basis differences listed below, determine the change in Kantner's deferred tax assets for the current year.

	Beginning of Year
Accrued warranty expense	$30,000
Subtotal	$30,000
Applicable tax rate	× 34%
Gross deferred tax asset	$10,200

43. **LO.2** Based on the facts and results of Problem 41 and the beginning-of-the-year book-tax basis differences listed below, determine the change in Kantner's deferred tax liabilities for the current year.

	Beginning of Year
Building—accumulated depreciation	($62,000)
Furniture & fixtures—accumulated depreciation	(400)
Subtotal	($62,400)
Applicable tax rate	× 34%
Gross deferred tax liability	($21,216)

44. **LO.2** Based on the facts and results of Problems 41–43, determine Kantner's change in net deferred tax asset or net deferred tax liability for the current year. Provide the journal entry to record this amount.

45. **LO.2** In addition to the temporary differences identified in Problems 41–44, Kantner reported two permanent book-tax differences. It earned $7,800 in tax-exempt municipal bond interest, and it reported $850 in nondeductible meals and entertainment expense. Kantner's book income before tax is $50,000. With this additional information, calculate Kantner's current tax expense.

46. **LO.2** Provide the journal entry to record Kantner's current tax expense as determined in Problem 45.

47. **LO.2** Based on the facts and results of Problems 41–46, calculate Kantner's total provision for income tax expense reported on its financial statement, and its book net income after tax.

48. **LO.2** Based on the facts and results of Problems 41–47, provide the income tax footnote rate reconciliation for Kantner.

Bridge DISCIPLINE

1. Using publicly available web resources, locate summary financial information for two companies in the same industry. Compare and contrast the following items across the two companies: debt-to-equity ratio, return on assets, return on equity, inventory turnover ratio, and effective tax rate.

COMMUNICATIONS

2. Using publicly available web information, locate news or other items reporting financial analysts' forecasts or other information regarding two different companies. Determine whether the analyst appears to use tax information in the report. For example, does the analyst use pretax or after-tax earnings in the analysis? Draft an e-mail to your instructor describing your findings.

3. Using the annual reports or 10-Ks of two different public companies in the same industry, locate information regarding the compensation paid to their executives. Prepare a table comparing the compensation levels (cash and noncash) of top executives across the two companies. Illustrate the relationship between executive compensation and company performance by comparing the compensation to other company information such as net income.

RESEARCH PROBLEMS

INTERNET *activity*

Use the tax resources of the Internet to address the following questions. Do not restrict your search to the Web, but include a review of newsgroups and general reference materials, practitioner sites and resources, primary sources of the tax law, chat rooms and discussion groups, and other opportunities.

COMMUNICATIONS

Research Problem 1. Locate the web page of Citizens for Tax Justice and find the report "Corporate Income Taxes in the 1990s." Using this report, identify the effective tax rates of three companies, as estimated in the report. Also locate the financial statements of these

three companies (using the companies' websites or the SEC's website **www.sec.gov**). From the financial statement income tax note, identify the reported effective tax rate from the rate reconciliation for each company. Compare and contrast the financial statement effective tax rates with those estimated by the Citizens for Tax Justice report. Summarize this information in an e-mail to your instructor.

Research Problem 2. Locate the most recent financial statements of two companies in the same industry using the companies' websites or the SEC's website (**www.sec.gov**). Perform a benchmarking analysis of the two companies' effective tax rates, components of the effective tax rate reconciliation, levels of deferred tax assets and liabilities, and other relevant data. Summarize this information in an e-mail to your instructor. COMMUNICATIONS

Research Problem 3. Search the news archives available on the Web and locate four articles addressing the controversy over whether stock options should be included as a compensation expense on a company's income statement. Summarize these articles and write one or two paragraphs stating your own position on the FASB-mandated reporting of stock options as an expense. Send your report as an e-mail to your instructor. COMMUNICATIONS

Research Problem 4. Both Schedule M–1 and Schedule M–3 of Form 1120 provide a reconciliation of book income to taxable income. Locate the instructions for both these schedules at the IRS website (**www.irs.gov**) and review the definition of book income for purposes of the two schedules. Identify three specific items included in the Schedule M–3 determination of book income and discuss why these items are useful in determining a corporation's appropriate book income to use in the reconciliation. Send your comments as an e-mail to your instructor. COMMUNICATIONS

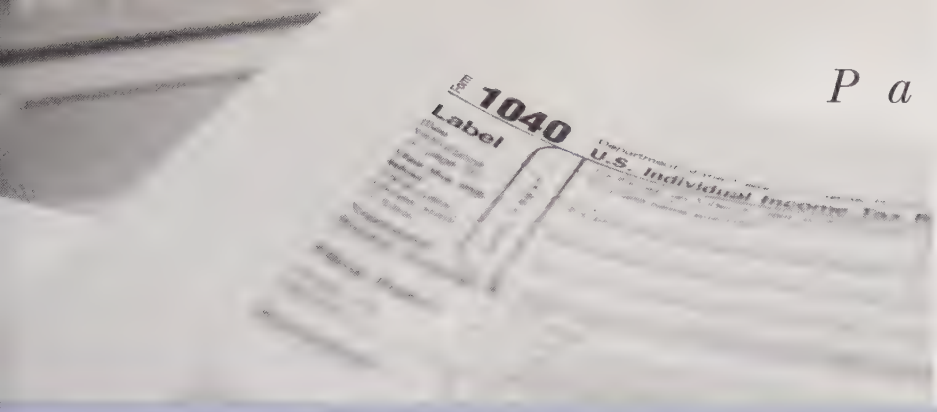
Research Problem 5. The issuance of Financial Interpretation No. 48 (FIN 48), *Accounting for Uncertainty in Income Taxes*, by the FASB was perhaps the most significant event affecting the reporting of a company's income tax expense since the adoption of SFAS 109. The history of FIN 48 was not without controversy. Do an Internet search for items related to ASC 740 (FIN 48) and its early exposure drafts. Draft a short memo outlining the arguments made for and against the approach contained in ASC 740 (FIN 48). Send your memo by e-mail to your instructor. COMMUNICATIONS

Research Problem 6. Locate the financial statements of three different companies that report information in the income tax footnote regarding uncertain tax positions under ASC 740 (FIN 48). Create a schedule that compares and contrasts the changes in uncertain tax positions reported by the three companies. E-mail the schedule to your instructor. COMMUNICATIONS

Research Problem 7. Locate the financial statements of three different companies. Review the income tax footnote information on deferred tax assets (DTAs) and deferred tax liabilities (DTLs). Create a schedule that compares and contrasts the end-of-the year amounts of DTAs and DTLs, including any valuation allowances. E-mail the schedule to your instructor. COMMUNICATIONS

Research Problem 8. Use any available resources (databases, the Web, etc.) to locate articles or other discussions regarding the key differences between ASC 740 (SFAS 109) and International Accounting Standard No. 12 (related to income taxes). Summarize these key differences in an e-mail to your instructor, citing your sources. COMMUNICATIONS

Research Problem 9. Locate the financial statements of two different companies in two different industries that appear to have very different state and local tax burdens, based on the rate reconciliation contained in the income tax footnote. Describe the difference in state and local effective rates and provide your thoughts on why the industry may be a factor in the differing state and local average tax rates. E-mail this discussion to your instructor. COMMUNICATIONS



Part 2

Structure of the Federal Income Tax

CHAPTER 4 Gross Income

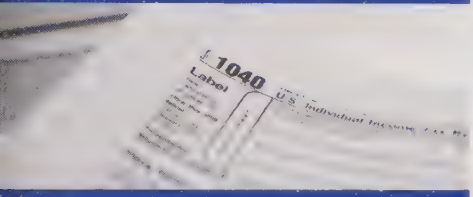
CHAPTER 5 Business Deductions

CHAPTER 6 Losses and Loss Limitations

Part 2 introduces the components of the basic tax model. The gross income component, including the effect of exclusions, the accounting period, and the accounting method, are presented. This presentation is followed by an analysis of business deductions, including deductions that are allowed, deductions that are disallowed, and the effect of the accounting period and the accounting method on the timing of deductions. Included in the presentation are the deduction for charitable contributions, research and experimental expenditures, production activities, interest and taxes, cost recovery, amortization, and depletion. Part 2 concludes with a discussion of losses. Included are coverage on bad debts, casualty and theft losses, net operating losses, the tax shelter issue, the at-risk limitations, and the passive activity loss limitations.

CHAPTER 4

Gross Income



LEARNING OBJECTIVES

After completing Chapter 4, you should be able to:

LO.1 Explain the **concepts of gross income and realization** and distinguish between the economic, accounting, and tax concepts of gross income. **(pp. 4-4 to 4-7)**

LO.2 Understand when the cash, accrual, and hybrid **methods of accounting** are used and how they are applied. **(pp. 4-7 to 4-13)**

LO.3 Identify **who should pay the tax** on an item of income. **(pp. 4-13 to 4-18)**

LO.4 Understand that **statutory authority is required to exclude** an item from gross income. **(p. 4-18)**

LO.5 Apply the Internal Revenue Code provisions on **loans made at below-market interest rates**. **(pp. 4-19 to 4-22)**

LO.6 Determine the extent to which receipts can be excluded under the **tax benefit rule**. **(p. 4-22)**

LO.7 Understand the Internal Revenue Code provision that excludes **interest on state and local government obligations** from gross income. **(pp. 4-22 to 4-24)**

LO.8 Use the Internal Revenue Code's exclusion of **leasehold improvements** from gross income. **(p. 4-24)**

LO.9 Determine the extent to which **life insurance proceeds** are excluded from gross income. **(pp. 4-24 to 4-26)**

LO.10 Describe the circumstances under which income must be reported from the **discharge of indebtedness**. **(pp. 4-26 to 4-29)**

LO.11 Describe the general tax consequences of **property transactions**. **(pp. 4-29 to 4-31)**

TAX *Talk*

The first nine pages of the Internal Revenue Code define income. The remaining 1,100 pages spin the web of exceptions and preferences.

—Warren G. Magnuson

OUTLINE

4.1 The Tax Formula, 4-3
Components of the Tax Formula, 4-3
4.2 Gross Income—What Is It? 4-4
Economic and Accounting Concepts of Income, 4-4
Comparison of the Accounting and Tax Concepts of Income, 4-6
Form of Receipt, 4-6
4.3 Year of Inclusion, 4-7
Taxable Year, 4-7
Accounting Methods, 4-7
Special Rules for Cash Basis Taxpayers, 4-10
Special Rules for Accrual Basis Taxpayers, 4-12
4.4 Income Sources, 4-13
Personal Services, 4-13
Income from Property, 4-14
Income Received by an Agent, 4-17
4.5 Specific Items of Gross Income, 4-18
Imputed Interest on Below-Market Loans, 4-19
Tax Benefit Rule, 4-22
Interest on Certain State and Local Government Obligations, 4-22
Improvements on Leased Property, 4-24
Life Insurance Proceeds, 4-24
Income from Discharge of Indebtedness, 4-26
Gains and Losses from Property Transactions, 4-29

THE BIG PICTURE Tax Solutions for the Real World

JUST WHAT IS INCLUDED IN GROSS INCOME?

At the beginning of the year, Dr. Sid Stevens opens his new dental practice as a qualified personal service corporation. For his new business, he selects a December 31 year-end and the accrual method of accounting. During the year, Dr. Stevens billed patients and insurance companies for $485,000 of dental services. At the end of the year, $54,000 of this amount has not been collected. The corporation earns $500 of interest on a money market account held at the local bank and another $500 of interest on an investment in municipal bonds.

Dr. Stevens's salary from his corporation is $10,000 per month. However, he did not cash his December payroll check until January. To help provide funds to invest in the new business, Dr. Stevens's parents loaned him $150,000 and did not charge him any interest. He also owns stock that has increased in value from $7,000 at the beginning of the year to more than $25,000 at the end of the year.

Although Dr. Stevens took several accounting classes in college, he would like your help in calculating his gross income and the gross income of the corporation. **Read the chapter and formulate your response.**

Mary purchases a number of computer components from a supplier for $500. She hires an employee to assemble them into a computer that has a market value of $1,100. Keith, one of Mary's long-time customers, has been especially effective in sending new business to Mary's operation, so Mary sells the computer to Keith for $950. Direct labor costs for the computer totaled $150, and an allocable share of Mary's overhead for the current sale was determined to be $40.

Keith called in his order on December 15, 2010. Because he was going to be out of town, Keith told Mary to bring the computer to his office on January 6, 2011. The computer was fully assembled on December 22, 2010, but Mary delivered the machine on January 6, 2011.

Mary does business in a storefront in the local strip mall, using the name Home-Made Computers. Home-Made is a partnership, owned equally by Mary and her sister Sherry.

Some variation of this simple scenario is carried out millions of times every day in today's global economy. Several broad tax questions, such as the following, arise as a result of these transactions.

- *What:* What is income?
- *When:* In which tax period is the income recognized?
- *Who:* Who is taxed on the income?

4.1 The Tax Formula

The basic income tax formula was introduced in Chapter 1 and summarized in Figure 1.1. This chapter, together with Chapters 5 through 8, examines the elements of this formula in detail. However, before embarking on a detailed study of the income tax, a brief introduction of each component of the tax formula is provided below as an overview.

COMPONENTS OF THE TAX FORMULA

Income (Broadly Conceived)

This includes all of the taxpayer's income, both taxable and nontaxable. Although it essentially is equivalent to gross receipts, it does not include a return of capital or borrowed funds.

Exclusions

For various reasons, Congress has chosen to exclude certain types of income from the income tax base. The principal income exclusions that apply to all entities (e.g., life insurance proceeds received by reason of death of the insured and state and local bond interest) are discussed later in this chapter, while exclusions that are unique to individuals are addressed in Chapters 16 and 17.

Gross Income

Section 61 of the Internal Revenue Code provides the following definition of **gross income**.

> Except as otherwise provided in this subtitle, gross income means all income from whatever source derived.

This language is derived from the Sixteenth Amendment to the Constitution. The "except as otherwise provided" phrase refers to exclusions.

Supreme Court decisions have made it clear that *all* sources of income are subject to tax unless Congress specifically excludes the type of income received.

> The starting point in all cases dealing with the question of the scope of what is included in "gross income" begins with the basic premise that the purpose of Congress was to use the full measure of its taxing power.[1]

While it is clear that income is to be broadly construed, the statutory law fails to provide a satisfactory definition of the term and lists only a small set of items that are specifically included in income, including:

- Compensation for services.
- Business income.
- Gains from sales and other disposition of property.
- Interest.
- Dividends.
- Rents and royalties.
- Certain income arising from discharge of indebtedness.
- Income from partnerships.

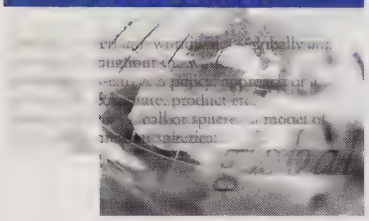
Deductions

Generally, all ordinary and necessary trade or business expenses are deductible by taxpaying entities. Such expenses include the cost of goods sold, salaries, wages, operating expenses (such as rent and utilities), research and development expenditures, interest, taxes, depreciation, amortization, and depletion.

As noted in Chapter 1, individuals can use two categories of deductions—deductions *for* AGI and deductions *from* AGI. In addition, individuals are unique

[1] *James v. U.S.*, 61–1 USTC ¶9449, 7 AFTR 2d 1361, 81 S.Ct. 1052 (USSC, 1961).

GLOBAL *Tax Issues*



From "All Sources" Is a Broad Definition

When § 61 refers to "income from whatever source derived," the taxing authorities are reaching far beyond the borders of the United States. Although one interpretation of "source" in this context is type of income (wages, interest, etc.), a broader interpretation revolves around the place where the income is generated. In this context, citizens and residents of the United States are subject to taxation on income earned from sources both inside and outside the country. This "worldwide income" tax base can cause potential double taxation problems, with other countries also taxing income earned within their borders, but mechanisms such as the foreign tax credit can alleviate these tax burdens.

Recently, some U.S. corporations have relocated to other countries to avoid the higher U.S. tax rates on income earned abroad.

among taxpaying entities in that they are permitted to deduct a variety of personal expenses (i.e., expenses unrelated to business or investment), they are allowed a standard deduction if this amount exceeds the deductible personal expenses, and they are allowed a deduction for personal and dependency exemptions.

Determining the Tax

Taxable income is determined by subtracting deductions (after any applicable limitations) from gross income. The tax rates (located on the inside front cover of this text) then are applied to determine the tax. Finally, tax prepayments (such as Federal income tax withholding on salaries and estimated tax payments) and a wide variety of credits are subtracted from the tax to determine the amount due to the Federal government or the refund due to the taxpayer.

4.2 Gross Income—What Is It?

LO.1

Explain the concepts of gross income and realization and distinguish between the economic, accounting, and tax concepts of gross income.

Economic and Accounting Concepts of Income

As noted above, Congress failed to provide in the Code a clear definition of income. Instead, it was left to the judicial and administrative branches of government to thrash out the meaning of income. As the income tax law developed, two competing models of income were considered by these agencies: economic income and accounting income.

The term **income** is used in the Code but is defined very broadly. Early in the history of our tax laws, the courts were required to interpret "the commonly understood meaning of the term which must have been in the minds of the people when they adopted the Sixteenth Amendment."[2]

Economists measure income (**economic income**) by determining the change (increase or decrease) in the fair market value of the entity's assets (net of liabilities) from the beginning to the end of the year. This focus on change in *net worth* as a measure of income (or loss) requires no disposition of assets. For *individual* taxpayers, one adds the value of the year's personal consumption of goods and services (e.g., food, the rental value of owner-occupied housing, etc.).[3]

EXAMPLE 1

Helen's economic income is calculated by comparing her net worth at the end of the year (December 31) with her net worth at the beginning of the year (January 1) and adding her personal consumption.

[2] *Merchants Loan and Trust Co. v. Smietanka*, 1 USTC ¶42, 3 AFTR 3102, 41 S.Ct. 386 (USSC, 1921).

[3] See Henry C. Simons, *Personal Income Taxation* (Chicago: University of Chicago Press, 1933), Chapters 2–3.



Bridge to Financial Accounting

Accountants use a definition of income that relies on the realization principle.[4] **Accounting income** is not recognized until it is realized. For realization to occur:

- An exchange of goods or services must take place between the entity and some independent, external party, and
- The goods or services received by the entity must be capable of being objectively valued.[5]

Thus, an increase in the fair market value of an asset before its sale or other disposition is not sufficient to trigger the recognition of accounting income. Similarly, the imputed savings that arise when an entity creates assets for its own use (e.g., feed grown by a farmer for his or her livestock) do not constitute accounting income because no exchange has occurred.

Business taxpayers often reconcile their annual income computations for financial accounting and tax law purposes. Taxpayers required to prepare audited financial statements must explain in the footnotes to the statements (1) the most important accounting principles used in computing book income, and (2) the most important tax elections and other consequences of the tax law on earnings per share.

Fair market value of Helen's assets on December 31	$220,000	
Less liabilities on December 31	(40,000)	
Net worth on December 31		$ 180,000
Fair market value of Helen's assets on January 1	$200,000	
Less liabilities on January 1	(80,000)	
Net worth on January 1		(120,000)
Increase in net worth		$ 60,000
Consumption		
Food, clothing, and other personal expenditures	$ 25,000	
Imputed rental value of the home Helen owns and occupies	12,000	
Total consumption		37,000
Economic income		$ 97,000

■

The tax law relies to some extent on net worth as a measure of income.[6] Potentially, anything that increases net worth is income, and anything that decreases net worth is deductible (if permitted by statute). Thus, *windfall income* such as buried treasure found in one's backyard is taxable under the theory that net worth has been increased.[7] Likewise, a lender does *not* recognize gross income on receipt of loan principal repayments. The lender's investment simply changes from a loan receivable to cash, so net worth does not change.

Because the strict application of a tax based on economic income would require taxpayers to determine the value of their assets annually, compliance would be burdensome. Controversies between taxpayers and the IRS inevitably would arise under an economic approach to income determination because of the subjective nature of valuation in many circumstances. In addition, using market values to determine income for tax purposes could result in liquidity problems. That is, a taxpayer's assets could increase in value but not be easily converted into the cash needed to pay the resulting tax (e.g., increases in the value of commercial real estate).[8] Thus, the IRS, Congress, and the courts have rejected broad application of the economic income concept as impractical.

[4]See the American Accounting Association Committee Report on the "Realization Concept," *The Accounting Review* (April 1965): 312–322.

[5]Valuation is carried out in the local currency of the reporting entity.

[6]*Comm. v. Glenshaw Glass Co.*, 55–1 USTC ¶9308, 47 AFTR 162, 348 U.S. 426 (USSC, 1955).

[7]*Cesarini v. U.S.*, 69–1 USTC ¶9270, 23 AFTR 2d 69–997, 296 F.Supp. 3 (D.Ct. N.Oh., 1969), *aff'd* 70–2 USTC ¶9509, 26 AFTR 2d 70–5107, 428 F.2d 812 (CA–6, 1970); Rev.Rul. 61, 1953–1 C.B. 17.

[8]In Chapter 1, this was identified as a justification of the wherewithal to pay concept.

TAX in the NEWS

The Tax Gap

The "tax gap" is an estimate of the difference between what taxpayers should pay and what they actually pay in Federal income taxes each year. It is one of the yardsticks used to measure the effectiveness of the Federal income tax system. According to Treasury Department estimates, the tax gap is more than $300 billion per year. Some of the gap is due to deliberate actions by taxpayers, but much of the gap occurs because taxpayers do not understand the tax law. For example, in a recent survey 60 percent of the respondents said they would not report as gross income the amounts they won betting on the NCAA basketball tournament. Only 35 percent were aware that their winnings were taxable.

Approximately 80 percent of the tax gap is attributed to income being understated or expenses being overstated. Failure to report income is the most common problem, accounting for 80 percent of the improper individual tax returns filed. Income from small businesses is most likely to be underreported; taxpayers are more likely to report accurate amounts for their wage and investment income properly.

The tax gap is a concern because it adds to the national deficit and may reduce the level and quality of government services that can be provided. Furthermore, it raises an equity issue: when some taxpayers fail to pay what they owe, whether out of dishonesty or confusion, they shift more of the tax burden onto the taxpayers who pay their taxes in full.

COMPARISON OF THE ACCOUNTING AND TAX CONCEPTS OF INCOME

Although income tax rules frequently parallel financial accounting measurement concepts, differences do exist. Of major significance, for example, is the fact that unearned (prepaid) income received by an accrual basis taxpayer often is taxed in the year of receipt. For financial accounting purposes, such prepayments are not treated as income until earned. Because of this and other differences, many corporations report financial accounting income that is substantially different from the amounts reported for tax purposes.

The Supreme Court provided an explanation for some of the variations between accounting and taxable income in a decision involving inventory and bad debt adjustments.

> The primary goal of financial accounting is to provide useful information to management, shareholders, creditors, and others properly interested; the major responsibility of the accountant is to protect these parties from being misled. The primary goal of the income tax system, in contrast, is the equitable collection of revenue. . . . Consistently with its goals and responsibilities, financial accounting has as its foundation the principle of conservatism, with its corollary that "possible errors in measurement [should] be in the direction of understatement rather than overstatement of net income and net assets." In view of the Treasury's markedly different goals and responsibilities, understatement of income is not destined to be its guiding light. . . .
>
> Financial accounting, in short, is hospitable to estimates, probabilities, and reasonable certainties; the tax law, with its mandate to preserve the revenue, can give no quarter to uncertainty.[9]

FORM OF RECEIPT

Gross income is not limited to cash received. "It includes income realized in any form, whether in money, property, or services. Income may be realized [and recognized], therefore, in the form of services, meals, accommodations, stock or other property, as well as in cash."[10]

[9] *Thor Power Tool Co. v. Comm.*, 79–1 USTC ¶9139, 43 AFTR 2d 79–362, 99 S.Ct. 773 (USSC, 1979).

[10] Reg. § 1.61–1(a).

EXAMPLE 2

Ostrich Corporation allows Cameron, an employee, to use a company car for his vacation. Cameron realizes income equal to the rental value of the car for the time and mileage. ■

EXAMPLE 3

Plover, Inc., owes $10,000 on a mortgage. The creditor accepts $8,000 in full satisfaction of the debt. Plover realizes income of $2,000 from retiring the debt.[11] ■

EXAMPLE 4

Donna is a CPA specializing in individual tax return preparation. Her neighbor, Jill, is a dentist. Each year, Donna prepares Jill's tax return in exchange for two dental checkups. Jill and Donna both have gross income equal to the fair market value of the services they provide. ■

4.3 Year of Inclusion

TAXABLE YEAR

The annual accounting period or **taxable year** is a basic component of our tax system. Generally, an entity must use the *calendar year* to report its income. However, a *fiscal year* (a period of 12 months ending on the last day of any month other than December) can be elected if the taxpayer maintains adequate books and records. This fiscal year option generally is not available to partnerships, S corporations, and personal service corporations.

Determining the tax year in which the income is recognized is important for determining the tax consequences of the income.

- With a progressive tax rate system, a taxpayer's marginal tax rate can change from year to year.
- Congress may change the tax rates.
- The relevant rates may change because of a change in the entity's status (e.g., a proprietorship may incorporate).
- Several provisions in the Code depend on the taxpayer's income for the year (e.g., the charitable contribution deduction).

ACCOUNTING METHODS

LO.2

Understand when the cash, accrual, and hybrid methods of accounting are used and how they are applied.

The year in which an item of income is subject to tax often depends upon the **accounting method** the taxpayer employs. The three primary methods of accounting are (1) the cash receipts and disbursements method, (2) the accrual method, and (3) the hybrid method. Most individuals use the cash receipts and disbursements method of accounting, whereas most larger corporations use the accrual method. Because the Regulations require the accrual method for determining purchases and sales when inventory is an income-producing factor,[12] some businesses employ a hybrid method that is a combination of the cash and accrual methods.

In addition to these overall accounting methods, a taxpayer may choose to spread the gain from an installment sale of property over the collection period by using the *installment method* of income recognition. Contractors may either spread profits from contracts over the period in which the work is done (the *percentage of completion method*) or defer all profit until the year in which the project is completed (the *completed contract method*) in limited circumstances.[13]

The IRS has the power to prescribe the accounting method to be used by the taxpayer. The IRS holds broad powers to determine if the accounting method used *clearly reflects income.*

> If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary . . . does clearly reflect income.[14]

[11]Reg. § 1.61–12. See *U.S. v. Kirby Lumber Co.*, 2 USTC ¶814, 10 AFTR 458, 52 S.Ct. 4 (USSC, 1931). Exceptions to this general rule exist.

[12]Reg. § 1.446–1(c)(2)(i).

[13]§§ 453 and 460.

[14]§ 446(b).

TAX in the NEWS

Academy Awards Presenters Must "Walk the Line"

Movie stars and other film industry luminaries who make the presentations at the Academy Awards ceremony receive "gift baskets" for participating in the event. The gift baskets include expense-paid vacations, pearls, chocolates, clothing, and a variety of other items. The IRS has estimated that the value of some of the baskets has exceeded $100,000.

The Commissioner of the IRS has put Hollywood on notice that "movie stars face the same obligation as ordinary Americans." Thus, the presenters must include the value of the basket contents in their gross income.

Cash Receipts Method

Under the **cash receipts method**, property or services received are included in the taxpayer's gross income in the year of actual or constructive receipt by the taxpayer or agent, regardless of whether the income was earned in that year.[15] The income received need not be reduced to cash in the same year. All that is necessary for income recognition is that property or services received be measurable by a fair market value.[16] Thus, a cash basis taxpayer that receives a note in payment for services has income in the year of receipt equal to the fair market value of the note. However, a creditor's mere promise to pay (e.g., an account receivable), with no supporting note, usually is not considered to have a fair market value.[17] Thus, the cash basis taxpayer defers income recognition until the account receivable is collected.

EXAMPLE 5

Finch & Thrush, a CPA firm, uses the cash receipts method of accounting. In 2010, the firm performs an audit for Orange Corporation and bills the client for $5,000, which is collected in 2011. In 2010, the firm also performs an audit for Blue Corporation. Because of Blue's precarious financial position, Finch & Thrush requires Blue to issue an $8,000 secured negotiable note in payment of the fee. The note has a fair market value of $6,000. The firm collects $8,000 on the note in 2011. Finch & Thrush has the following gross income for the two years.

	2010	2011
Fair market value of note received from Blue	$6,000	
Cash received		
From Orange on account receivable		$ 5,000
From Blue on note receivable		8,000
Less: Recovery of capital	–0–	(6,000)
Total gross income	$6,000	$ 7,000

■

Generally, a check received is a cash equivalent. Thus, a cash basis taxpayer recognizes the income when the check is received. This is true even if the taxpayer receives the check after banking hours. An exception to this rule is that if the person paying with the check requests that the check not be cashed until a subsequent date, the cash basis income is deferred until the date the check can be cashed.[18]

Certain taxpayers are not permitted to use the cash method of accounting regardless of whether inventories are material. Specifically, the accrual basis must be used to report the income earned by (1) corporations (other than S corporations),

[15] *Julia A. Strauss*, 2 B.T.A. 598 (1925). The doctrine of *constructive receipt* holds that if income is unqualifiedly available although not physically in the taxpayer's possession, it is subject to the income tax. An example is accrued interest on a savings account. Under the doctrine of constructive receipt, the interest is taxed to a depositor in the year available, rather than the year actually withdrawn. The fact that the depositor uses the cash basis of accounting for tax purposes is irrelevant. Reg. § 1.451–2.

[16] Reg. §§ 1.446–1(a)(3) and (c)(1)(i).

[17] *Bedell v. Comm.*, 1 USTC ¶359, 7 AFTR 8469, 30 F.2d 622 (CA–2, 1929).

[18] *Charles F. Kahler*, 18 T.C. 31 (1952); *Bright v. U.S.*, 91–1 USTC ¶50,142, 67 AFTR 2d 91–673, 926 F.2d 383 (CA–5, 1991).

Bridge DISCIPLINE

Bridge to Economics and Finance

Nontaxable Economic Benefits

Home ownership is the prime example of economic income from capital that is not subject to tax. If the taxpayer uses his or her capital to purchase investments, but pays rent on a personal residence, the taxpayer would pay the rent from after-tax income. However, if the taxpayer purchases a personal residence instead of the investments, he or she would give up gross income from the forgone investments in exchange for the rent savings. The savings in rent enjoyed as a result of owning the home are not subject to tax. Thus, the homeowner has substituted nontaxable for taxable income.

Tax Deferral

Since deferred taxes are tantamount to interest-free loans from the government, the deferral of taxes is a worthy goal of the tax planner. However, the tax planner also must consider the tax rates for the years the income is shifted from and to. For example, a one-year deferral of income from a year in which the taxpayer's tax rate was 28 percent to a year in which the tax rate will be 35 percent would not be advisable if the taxpayer expects to earn less than a 7 percent after-tax return on the deferred tax dollars.

The taxpayer often can defer the recognition of income from appreciated property by postponing the event triggering realization (the final closing on a sale or exchange of property). If the taxpayer needs cash, obtaining a loan by using the appreciated property as collateral may be the least costly alternative. When the taxpayer anticipates reinvesting the proceeds, a sale may be inadvisable.

EXAMPLE

Ira owns 100 shares of Pigeon Company common stock with a cost of $20,000 and a fair market value of $50,000. Although the stock's value has increased substantially in the past three years, Ira thinks the growth days are over. If he sells the Pigeon stock, Ira will invest the proceeds from the sale in other common stock. Assuming Ira's marginal tax rate on the sale is 15%, he keeps only $45,500 [$50,000 − .15 ($50,000 − $20,000)] to reinvest. The alternative investment must substantially outperform Pigeon in the future for the sale to be beneficial. ■

(2) partnerships with a corporate partner, and (3) tax shelters.[19] A number of other businesses still can use the cash method.

- A farming business.
- A qualified personal service corporation (e.g., a corporation performing services in health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting).
- Any entity that is not a tax shelter whose average annual gross receipts for the most recent three-year period are $5 million or less.[20]

Tax Planning Strategies

Cash Receipts Method

FRAMEWORK FOCUS: INCOME

Strategy: Postpone Recognition of Income to Achieve Tax Deferral.

FRAMEWORK FOCUS: TAX RATE

Strategy: Shift Net Income from High-Bracket Years to Low-Bracket Years.

The timing of income from services often can be controlled through the cash method of accounting. The usual lag between billings and collections (e.g., December's billings collected in January) can result in a deferral of some income until the last year of operations. For example, before rendering services, a corporate officer approaching retirement may contract with the corporation to defer a portion of his or her compensation to the lower tax bracket retirement years.

[19] § 448(a).

[20] § 448(b). Rev.Proc. 2002–28, 2002–1 C.B. 815

Accrual Method

Under the **accrual method**, an item generally is included in gross income for the year in which it is earned, regardless of when the income is collected. The income is earned when (1) all the events have occurred that fix the right to receive the income and (2) the amount to be received can be determined with reasonable accuracy.[21]

Generally, the taxpayer's rights to the income accrue when title to property passes to the buyer or the services are performed for the customer or client.[22] If the rights to the income have accrued but are subject to a potential refund claim (e.g., under a product warranty), the income is reported in the year of sale, and a deduction is allowed in subsequent years when actual claims accrue.[23]

Where the taxpayer's rights to the income are being contested (e.g., when a contractor fails to meet specifications), gross income is recognized only when payment has been received.[24] If the payment is received before the dispute is settled, however, the court-made **claim of right doctrine** requires the taxpayer to recognize the income in the year of receipt.[25]

If Finch & Thrush in Example 5 uses the accrual basis of accounting, it recognizes $13,000 ($8,000 + $5,000) income in 2010, the year its rights to the income accrue.

EXAMPLE 7

Tangerine Construction, Inc., completes construction of a building in 2010 and presents a bill to the customer. The customer refuses to pay the bill and claims that Tangerine has not met specifications. A settlement with the customer is not reached until 2011. No income accrues to Tangerine until 2011. Alternatively, if the customer pays for the work and then files suit for damages, Tangerine cannot defer the income, and it is taxable in 2010. ■

Hybrid Method

The accrual method is used to determine sales and cost of goods sold. To simplify record keeping, some taxpayers account for inventory using the accrual method and use the cash method for all other income and expense items. This approach, called the **hybrid method**, is used primarily by small businesses when inventory is a material income-producing factor.

SPECIAL RULES FOR CASH BASIS TAXPAYERS

Constructive Receipt

Income that has not actually been received by the taxpayer is taxed as though it had been received—the income is constructively received—under the following conditions.

- The amount is made readily available to the taxpayer.
- The taxpayer's actual receipt is not subject to substantial limitations or restrictions.[26]

The rationale for the **constructive receipt** doctrine is that if the income is available, the taxpayer should not be allowed to postpone income recognition. For instance, a taxpayer is not permitted to defer income for December services by refusing to accept payment until January.

EXAMPLE 8

Rob, a physician, conducts his medical practice as a sole proprietorship. Rob is also a member of a barter club. In 2010, Rob provided medical care for other club members

[21] Reg. § 1.451–1(a).

[22] *Lucas v. North Texas Lumber Co.*, 2 USTC ¶484, 8 AFTR 10276, 50 S.Ct. 184 (USSC, 1930).

[23] *Brown v. Helvering*, 4 USTC ¶1222, 13 AFTR 851, 54 S.Ct. 356 (USSC, 1933).

[24] *Burnet v. Sanford and Brooks*, 2 USTC ¶636, 9 AFTR 603, 51 S.Ct. 150 (USSC, 1931).

[25] *North American Oil Consolidated Co. v. Burnet*, 3 USTC ¶943, 11 AFTR 16, 52 S.Ct. 613 (USSC, 1932).

[26] Reg. § 1.451–2(a).

and earned 3,000 points. Each point entitles him to $1 in goods and services sold by other members of the club; the points can be used at any time. In 2011, Rob exchanged his points for a new high definition TV. Rob recognizes $3,000 gross income in 2010, when the 3,000 points were credited to his account.[27] ■

On December 31, an employer issued a bonus check to an employee but asked her to hold it for a few days until the company could make deposits to cover the check. The income was not constructively received on December 31 since the issuer did not have sufficient funds in its account to pay the debt.[28] ■

Mauve, Inc., an S corporation, owned interest coupons that matured on December 31. The coupons can be converted to cash at any bank at maturity. Thus, the income was constructively received on December 31, even though Mauve failed to cash in the coupons until the following year.[29] ■

Flamingo Company mails dividend checks on December 31, 2010. The checks will not be received by the shareholders until January. The shareholders do not realize gross income until 2011.[30] ■

The constructive receipt doctrine does not reach income that the taxpayer is not yet entitled to receive even though the taxpayer could have contracted to receive the income at an earlier date.

Murphy offers to pay Peach Corporation (a cash basis taxpayer) $100,000 for land in December 2010. Peach Corporation refuses but offers to sell the land to Murphy on January 1, 2011, when the corporation will be in a lower tax bracket. If Murphy accepts Peach's offer, the gain is taxed to Peach in 2011 when the sale is completed.[31] ■

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.



Original Issue Discount

Lenders frequently make loans that require a payment at maturity of more than the amount of the original loan. The difference between the amount due at maturity and the amount of the original loan is actually interest but is referred to as **original issue discount**. Under the general rules of tax accounting, a cash basis lender would not report the original issue discount as interest income until the year the amount is collected, although an accrual basis borrower would deduct the interest as it is earned. However, the Code puts the lender and borrower on parity by requiring that the original issue discount be reported when it is earned, regardless of the taxpayer's accounting method.[32] The *interest earned* is calculated by the effective interest rate method.

On January 1, 2010, Blue and White, a cash basis partnership, pays $82,645 for a 24-month certificate of deposit. The certificate is priced to yield 10% (the effective interest rate) with interest compounded annually. No interest is paid until maturity, when Blue and White receives $100,000. Thus, the partnership's gross income from the certificate is $17,355 ($100,000 − $82,645). Blue and White calculates income earned each year as follows.

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[27] Rev.Rul. 80–52, 1980–1 C.B. 100.
[28] *L. M. Fischer*, 14 T.C. 792 (1950).
[29] Reg. § 1.451–2(b).
[30] Reg. § 1.451–2(b).
[31] *Cowden v. Comm.*, 61–1 USTC ¶9382, 7 AFTR 2d 1160, 289 F.2d 20 (CA–5, 1961).
[32] §§ 1272(a)(3) and 1273(a).

TAX in the NEWS

Congress Rescues Lottery Winners from Constructive Receipt Problems

Under the general rules of constructive receipt, a lottery winner who elected to receive the winnings in installments could face horrendous tax problems. If the winner had the right to receive the entire amount, but elected to be paid in installments, tax could be due on the present value of the amounts to be received in the future as well as the amount received currently. Frequently, the winner made the election without being aware of the tax consequences.

To protect poorly advised, or unadvised, lottery winners, Congress changed § 451(h) so that the constructive receipt doctrine will not apply to "qualified prizes," a term crafted specifically to address the lottery and prize winner's situation. Thus, lottery winnings can be received in installments and included in gross income as the installments are received.

2010 (0.10 × $82,645) =	$ 8,264
2011 [0.10 ($82,645 + $8,264)] =	9,091
	$17,355

■

The original issue discount rules do not apply to U.S. savings bonds or to obligations with a maturity date of one year or less from the date of issue.[33]

Amounts Received under an Obligation to Repay

The receipt of funds with an obligation to repay that amount in the future is the essence of borrowing. The taxpayer's assets and liabilities increase by the same amount, so no income is realized when the borrowed funds are received.

EXAMPLE 31

A landlord receives a damage deposit from a tenant. The landlord does not recognize income until the deposit is forfeited because the landlord has an obligation to repay the deposit if no damage occurs.[34] However, if the deposit is in fact a prepayment of rent, it is taxed in the year of receipt. ■

SPECIAL RULES FOR ACCRUAL BASIS TAXPAYERS

Prepaid Income

For financial reporting purposes, advance payments received from customers are reflected as prepaid income and as a liability of the seller. For tax purposes, however, the prepaid income often is taxed in the year of receipt.

EXAMPLE 32

In December 2010, a company pays its January 2011 rent of $1,000. The accrual basis landlord must include the $1,000 in 2010 gross income for tax purposes, although the unearned rent income is reported as a liability on the landlord's financial accounting balance sheet for December 31, 2010. ■

Deferral of Advance Payments for Goods

Generally, an accrual basis taxpayer can elect to defer recognition of income from advance payments for goods if the method of accounting for the sale is the same for tax and financial reporting purposes.[35]

EXAMPLE 33

Brown Company ships goods only after payment for the goods has been received. In December 2010, Brown receives $10,000 for goods that are not shipped until January 2011. Brown can elect to report the income in 2011 for tax purposes, assuming the company reports the income in 2011 for financial reporting purposes. ■

[33] § 1272(a)(2).
[34] *John Mantell*, 17 T.C. 1143 (1952).
[35] Reg. § 1.451–5(b). See Reg. § 1.451–5(c) for exceptions to this deferral opportunity.

Deferral of Advance Payments for Services

An accrual basis taxpayer can defer recognition of income for *advance payments for services* to be performed after the end of the tax year of receipt.[36] The portion of the advance payment that relates to services performed in the tax year of receipt is included in gross income in the tax year of receipt. The portion of the advance payment that relates to services to be performed after the tax year of receipt is included in gross income in the *tax year following the tax year of receipt* of the advance payment.

Advance payments for prepaid rent or prepaid interest always are taxed in the year of receipt.

EXAMPLE 17

Yellow Corporation, an accrual basis calendar year taxpayer, sells its services under 12-month, 24-month, and 36-month contracts. The corporation provides services to each customer every month. On May 1, 2010, Yellow Corporation sold the following customer contracts.

Length of Contract	Total Proceeds
12 months	$3,000
24 months	4,800
36 months	7,200

Yellow may defer until 2011 all of the income that will be earned after 2010.

Length of Contract	Income Recorded in 2010	Income Recorded in 2011
12 months	$2,000 ($3,000 × 8/12)	$1,000 ($3,000 × 4/12)
24 months	1,600 ($4,800 × 8/24)	3,200 ($4,800 × 16/24)
36 months	1,600 ($7,200 × 8/36)	5,600 ($7,200 × 28/36)

■

Tax Planning Strategies PREPAID INCOME

FRAMEWORK FOCUS: INCOME

Strategy: Postpone Recognition of Income to Achieve Tax Deferral.

The accrual basis taxpayer who receives advance payments from customers should structure the transactions using the rules discussed above to avoid a payment of tax on income before the time the income is actually earned.

In addition, both cash and accrual basis taxpayers sometimes can defer income by stipulating that the payments are deposits rather than prepaid income. For example, a tax-savvy landlord might consider requiring an equivalent damage deposit rather than prepayment of the last month's rent.

4.4 INCOME SOURCES

LO.3

Identify who should pay the tax on an item of income.

PERSONAL SERVICES

It is a well-established principle of taxation that income from personal services must be included in the gross income of the person who performs the services. This principle was first established in a Supreme Court decision, *Lucas v. Earl*.[37] Mr. Earl entered into a binding agreement with his wife under which Mrs. Earl was to receive one-half of Mr. Earl's salary. Justice Holmes used the celebrated **fruit and tree**

[36] Rev.Proc. 2004–34, 2004–1 C.B. 991.

[37] 2 USTC ¶496, 8 AFTR 10287, 50 S.Ct. 241 (USSC, 1930).

TAXin the NEWS

The General Welfare Exception

The broad concept of gross income and the government's role in promoting the general welfare sometimes are in conflict. For example, if the government makes payments to persons based on their need, it does not make sense for the government to extract a tax from those same individuals and thus reduce the relief it intended to confer. Therefore, the courts and the IRS have created the "general welfare exception," which excludes from gross income certain types of governmental payments that otherwise might be taxable under the broad gross income concept. To qualify for this exception, the payments must be:

- Made from a governmental welfare fund.
- Based on need.
- Not made as a payment for services.

The exception has been applied to a wide range of government payments,[38] including Federal grants to rebuild homes destroyed by Hurricane Katrina and to make mortgage payments for persons suffering severe hardship. It also applies to grants by state governments to motivate the purchase of appliances with an Energy Star rating.

metaphor to explain that the fruit (income) must be attributed to the tree from which it came (Mr. Earl's services). A mere **assignment of income** to another party does not shift the liability for the tax.

Services of an Employee

Services performed by an employee for the employer's customers are considered performed by the employer. Thus, the employer is taxed on the income from the services provided to the customer, and the employee is taxed on any compensation received from the employer.[39]

EXAMPLE 10

Dr. Carey incorporates her medical practice and enters into a contract to work for the corporation for a salary. All patients contract to receive their services from the corporation, and those services are provided through the corporation's employee, Dr. Carey. The corporation must include the patients' fees in its gross income. Dr. Carey includes her salary in gross income. The corporation deducts a reasonable salary paid to Dr. Carey. ■

DIGGING DEEPER 2

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

INCOME FROM PROPERTY

Income earned from property (interest, dividends, rent) is included in the gross income of the owner of the property. If a shareholder clips interest coupons from bonds shortly before the interest payment date and transfers the coupons to his or her solely owned corporation, the interest still is taxed to the shareholder.

Often income-producing property is transferred after income from the property has accrued but before the income is recognized under the transferor's method of accounting. The IRS and the courts have developed rules to allocate the income between the transferor and the transferee. These allocation rules are addressed below. Other allocation rules address income in community property states.

DIGGING DEEPER 3

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

[38] For example, see Rev.Rul. 2009–19, I.R.B. No. 28, 111.

[39] *Sargent v. Comm.*, 91–1 USTC ¶50,168, 67 AFTR 2d 91–718, 929 F.2d 1252 (CA–8, 1991).

TAX

How Much and What Type of Income?

Of the 143 million individual income tax returns filed for the 2007 tax year, 84 percent included wage or salary income, and about half included some amount of interest income. But except for these two categories, no other type of income was found in even a quarter of the returns filed. Sales of business assets were found on fewer than 1 percent of the returns, and about 3.5 percent of the returns included flow-through income or loss from partnerships and S corporations. Capital gains showed up on about a quarter of the returns, but only when distributions from mutual fund investments were included.

Interest

According to the tax law, interest accrues daily. Therefore, the interest for the period that includes the date of an asset transfer is allocated between the transferor and the transferee, based on the number of days during the period that each owned the property.

EXAMPLE 19

Floyd, a cash basis taxpayer, gives his son, Seth, bonds with a face amount of $10,000 and an 8% stated annual interest rate, payable December 31. The gift is made on January 31, 2010, and the interest is paid on December 31 of that year. Floyd recognizes $68 in interest income (8% × $10,000 × 31/365). Seth recognizes $732 in interest income ($800 − $68). ■

When the transferor recognizes gross income from the property depends upon the method of accounting and the manner in which the property was transferred. In the case of a gift of income-producing property, the donor's share of the accrued income is recognized at the time it would have been recognized had the donor continued to own the property.[40] If the transfer is a sale, however, the transferor recognizes the accrued income at the time of the sale because the accrued interest is included in the sales proceeds.

EXAMPLE 20

Assume the same facts as in Example 19, except that the interest payable on December 31 is not actually or constructively received by the bondholders until January 3, 2011. As a cash basis taxpayer, Floyd generally does not recognize interest income until it is received. If Floyd had continued to own the bonds, he would have included the interest in his gross income in 2011, the year he would have received it. Therefore, Floyd includes the $68 accrued income in his gross income as of January 3, 2011.

Further assume that Floyd sells identical bonds on the date of the gift. The bonds sell for $9,900, including accrued interest. On January 31, 2010, Floyd recognizes the accrued interest of $68 on the bonds sold. Thus, the selling price of the bonds is $9,832 ($9,900 − $68). ■

Dividends

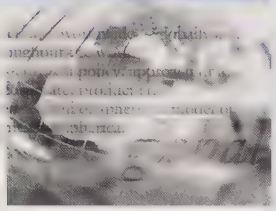
A corporation is taxed on its earnings, and the shareholders are taxed on the dividends paid to them from the corporation's after-tax earnings. The dividend can take the form of an actual dividend or a constructive dividend (e.g., shareholder use of corporate assets).

Partial relief from the double taxation of dividends has been provided in that dividends generally are taxed at the same marginal rate that is applicable to a net capital gain.[41] Individuals subject to the 25, 28, 33, or 35 percent marginal tax rate pay a

[40] Rev.Rul. 72–312, 1972–1 C.B. 22.

[41] § 1(h)(11).

GLOBAL *Tax Issues*



Which Foreign Dividends Get the Discounted Rate?

A dividend from a non-U.S. corporation is eligible for qualified dividend status only if one of the following requirements is met: (1) the foreign corporation's stock is traded on an established U.S. securities market, or (2) the foreign corporation is eligible for the benefits of a comprehensive income tax treaty or information-sharing agreement between its country of incorporation and the United States.

15 percent tax on qualified dividends received. Individuals otherwise subject to the 10 or 15 percent marginal tax rate pay a 0 percent rate tax on qualified dividends received in 2008, 2009, and 2010. Thus, *qualified dividends* receive favorable treatment as compared to interest income.

Note that qualified dividends are not treated as capital gains in the gains and losses netting process; thus, they are *not* reduced by capital losses. Qualified dividend income merely is taxed at the rates that would apply to the taxpayer if he or she had an excess of net long-term capital gain over net short-term capital loss.

Because the beneficial tax rate is intended to mitigate double taxation, only certain dividends are eligible for the beneficial treatment. Excluded are certain dividends from foreign corporations, dividends from tax-exempt entities, and dividends that do not satisfy the holding period requirement.

To satisfy the holding period requirement, the stock on which the dividend is paid must have been held for more than 60 days during the 120-day period beginning 60 days before the ex-dividend date.[42] The purpose of this requirement is to prevent the taxpayer from buying the stock shortly before the dividend is paid, receiving the dividend, and then selling the stock at a loss (a capital loss) after the stock goes ex-dividend. A stock's price often declines after the stock goes ex-dividend.

EXAMPLE 21

Green Corporation pays a 2010 dividend of $1.50 on each share of its common stock. Madison and Daniel, two unrelated shareholders, each own 1,000 shares of the stock. Consequently, each receives $1,500 (1,000 shares × $1.50). Assume Daniel satisfies the 60/120-day holding period rule, but Madison does not. The $1,500 Daniel receives is subject to preferential tax rate treatment. The $1,500 Madison receives, however, is not. Because Madison did not comply with the holding period rule, her dividend is not a *qualified dividend* and is taxed at ordinary income rates. ■

EXAMPLE 22

Assume that both Madison and Daniel in Example 21 are in the 35% tax bracket. Consequently, Madison pays a tax of $525 (35% × $1,500) on her dividend, while Daniel pays a tax of $225 (15% × $1,500) on his. The $300 saving that Daniel enjoys underscores the advantages of a qualified dividend. ■

Unlike interest, dividends do not accrue on a daily basis because the declaration of a dividend is at the discretion of the corporation's board of directors. Generally, dividends are taxed to the person who is entitled to receive them—the shareholder of record as of the corporation's record date.[43] Thus, if a taxpayer sells stock after a dividend has been declared but before the record date, the dividend generally will be taxed to the purchaser.

[42]The ex-dividend date is the date before the record date on which the corporation finalizes the list of shareholders who will receive the dividends.

[43]Reg. § 1.61–9(c). The record date is the cutoff for determining the shareholders who are entitled to receive the dividend.

TAX

Business Income and Loss

Sole proprietors reporting net business income or loss on Form 1040 constitute almost 16 percent of all returns filed. Flow-through income from partnerships and S corporations is found on only one-third as many returns, but the income reported is essentially the same in nominal dollars.

Flow-through income has increased dramatically and consistently since changes in marginal tax rates shifted in favor of individual rather than C corporation taxpayers.

If a donor makes a gift of stock to someone (e.g., a family member) after the declaration date but before the record date, the donor does not shift the dividend income to the donee. The *fruit* has ripened sufficiently as of the declaration date to tax the dividend income to the donor of the stock.[44] In another case, the dividend income was included in the gross income of the donee (the owner at the record date). The taxpayer had given the stock to a qualified charity (a charitable contribution) after the declaration date and before the record date.[45]

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

4 DIGGING DEEPER

EXAMPLE 23

On June 20, the board of directors of Black Corporation declares a $10 per share dividend. The dividend is payable on June 30, to shareholders of record on June 25. As of June 20, Kathleen owns 200 shares of Black Corporation's stock. On June 21, Kathleen sells 100 of the shares to Jon for their fair market value and gives 100 of the shares to Andrew (her son). Both Jon and Andrew are shareholders of record as of June 25. Jon (the purchaser) is taxed on $1,000 since he is entitled to receive the dividend. However, Kathleen (the donor) is taxed on the $1,000 received by Andrew (the donee) because the gift was made after the declaration date of the dividend. ■

INCOME RECEIVED BY AN AGENT

Income received by the taxpayer's agent is considered to be received by the taxpayer. A cash basis principal must recognize the income at the time it is received by the agent.[46]

EXAMPLE 24

Longhorn, Inc., a cash basis corporation, delivers cattle to the auction barn in late December. The auctioneer, acting as the corporation's agent, sells the cattle and collects the proceeds in December. The auctioneer does not pay Longhorn until the following January. The corporation must include the sales proceeds in its gross income in the year the auctioneer received the funds. ■

[44] *M. G. Anton*, 34 T.C. 842 (1960).

[45] *Caruth Corporation v. U.S.*, 89–1 USTC ¶9172, 63 AFTR 2d 89–716, 865 F.2d 644 (CA–5, 1989).

[46] Rev.Rul. 79–379, 1979–2 C.B. 204.

Tax Planning Strategies TECHNIQUES FOR REDUCING GROSS INCOME

FRAMEWORK FOCUS: INCOME

Strategy: Postpone Recognition of Income to Achieve Tax Deferral.

Because no tax is due until a gain has been recognized, the law favors investments that yield appreciation rather than annual income.

EXAMPLE 25

Vera can buy a corporate bond or an acre of land for $10,000. The bond pays $1,000 of interest (10%) each year, and Vera expects the land to increase in value 10% each year for the next 10 years. She is in the 40% (combined Federal and state) tax bracket for ordinary income and 26% for qualifying capital gains. If the bond would mature or the land would be sold in 10 years and Vera would reinvest the interest at a 10% before-tax return, she would accumulate the following amount at the end of 10 years.

		Bond	Land
Original investment		$10,000	$10,000
Annual income	$1,000		
Less tax	(400)		
	$ 600		
Compound amount reinvested for 10 years at 6% after-tax	×13.18	7,908	
Future value		$17,908	
Compound amount, 10 years at 10%			× 2.59
			$25,900
Less tax on sale: 26%($25,900 − $10,000)			(4,134)
Future value			$21,766

Therefore, the value of the deferral that results from investing in the land rather than in the bond is $3,858 ($21,766 − $17,908). ■

4.5 SPECIFIC ITEMS OF GROSS INCOME

LO.4
Understand that statutory authority is required to exclude an item from gross income.

The all-inclusive principles of gross income determination as applied by the IRS and the courts have, on occasion, been expanded or modified by Congress through legislation. This legislation generally provides more specific rules for determining gross income from certain sources. Most of these special rules appear in §§ 71–90 of the Code.

In addition to provisions describing how specific sources of gross income are to be taxed, several specific rules *exclude* items from gross income. Authority for excluding specific items is provided in §§ 101–150 and in various other provisions in the Code.

Many statutory exclusions are unique to *individual taxpayers* (e.g., gifts and inheritances,[47] scholarships,[48] and a variety of fringe benefits paid to *employees*). These exclusions are discussed in Chapters 16 and 17. Other exclusions are broader and apply to all entities. These exclusions include interest on state and local bonds (§ 103), life insurance proceeds received by reason of death of the insured (§ 101), the fair market value of leasehold improvements received by the lessor when a lease is terminated (§ 109),[49] and income from discharge of indebtedness (§ 108). Some of the broadly applied statutory rules describing inclusions and exclusions are discussed below.

[47] § 102.
[48] § 117.
[49] If the tenant made the improvements in lieu of rent payments, the value of the improvements is not eligible for exclusion.

TAX in the NEWS

LOANS TO EXECUTIVES PROHIBITED

Interest-free loans have become a popular form of compensation for executives. Several examples of multimillion dollar loans have come to light as a result of recent bankruptcies by large corporations. The board of directors often justifies the loans as necessary to enable the executive to be able to purchase a residence or to buy stock in the company.

Loans by publicly held corporations to their executives are now generally prohibited by Federal law. The Sarbanes-Oxley provisions generally prohibit loans by corporations to their executives. However, an exception permits corporate loans to finance the acquisition of a personal residence for an executive.

IMPUTED INTEREST ON BELOW-MARKET LOANS

LO.5

Apply the Internal Revenue Code provisions on loans made at below-market interest rates.

As discussed earlier in the chapter, generally no income is recognized unless it is realized. Realization occurs when the taxpayer performs services or sells goods and thus becomes entitled to a payment from the other party. It follows that no income is realized if the goods or services are provided at no charge. Under this prior-law interpretation of the realization requirement, interest-free loans were used to shift income between taxpayers.

EXAMPLE 76

Brown Corporation is in the 35% tax bracket and has $400,000 in a money market account earning 5% interest. Jack is the sole shareholder of Brown. He is in the 15% tax bracket and has no investment income. In view of the difference in tax rates, Jack believes that it would be better for him to receive and pay tax on the earnings from Brown's $400,000 investment. Jack does not wish to receive the $400,000 from Brown as a dividend because that would trigger a tax.

Under prior law, Jack could achieve his goals as follows. He could receive the money market account from Brown Corporation in exchange for a $400,000 non-interest-bearing note, payable on Brown's demand. As a result, Jack would receive the $20,000 annual earnings on the money market account, and the combined taxes of Brown Corporation and Jack would be decreased every year by $4,000.

Decrease in Brown's tax—(0.05 × $400,000) × 0.35	($7,000)
Increase in Jack's tax—(0.05 × $400,000) × 0.15	3,000
Overall decrease in tax liability	$4,000

■

The Code no longer allows this income-shifting result. Brown Corporation in the preceding example is deemed to have received an interest payment from Jack even though no interest was actually paid.[50] This payment of imputed interest is taxable to Brown. Jack may be able to deduct the imaginary interest payment on his return as investment interest if he itemizes deductions. To complete the fictitious series of transactions, Brown is deemed to return the interest to Jack in the form of a taxable dividend.

Imputed interest is calculated using rates the Federal government pays on new borrowings and is compounded semiannually. The Federal rates are adjusted monthly and are published by the IRS.[51] There are three Federal rates: short-term (not over three years and including demand loans), mid-term (over three years but not over nine years), and long-term (over nine years).

EXAMPLE 77

Assume the Federal rate applicable to the loan in the preceding example is 3.5% through June 30 and 4% from July 1 through December 31. Brown Corporation made the loan on January 1, and the loan is still outstanding on December 31. Brown

[50] § 7872(a)(1).

[51] §§ 7872(b)(2) and (f)(2).



CONCEPT SUMMARY 4.1

Effect of Certain Below-Market Loans on the Lender and Borrower

Type of Loan		Lender	Borrower
Gift	Step 1	Interest income	Interest expense
	Step 2	Gift made*	Gift received
Compensation related	Step 1	Interest income	Interest expense
	Step 2	Compensation expense	Compensation income
Corporation to shareholder	Step 1	Interest income	Interest expense
	Step 2	Dividend paid	Dividend income

*The gift may be subject to the Federal gift tax (refer to Chapter 1).

recognizes interest income of $15,140, and Jack reports interest expense of $15,140. Brown is deemed to have paid a $15,140 dividend to Jack.

Interest Calculations	
January 1 to June 30—(0.035 × $400,000) (½ year)	$ 7,000
July 1 to December 31—[0.04($400,000 + $7,000)] (½ year)	8,140
	$15,140

■

If interest is charged on the loan but is less than the Federal rate, the imputed interest is the difference between the amount that would have been charged at the Federal rate and the amount actually charged.

EXAMPLE 28

Assume the same facts as in Example 27, except that Brown Corporation charged 3% interest, compounded annually.

Interest at the Federal rate	$ 15,140
Less interest charged (0.03 × $400,000)	(12,000)
Imputed interest	$ 3,140

■

The imputed interest rules apply to the following types of below-market loans.[52]

1. Gift loans (made out of love, respect, or generosity).
2. Compensation-related loans (employer loans to employees).
3. Corporation-shareholder loans (a corporation's loans to its shareholders, as in Example 26).
4. Tax avoidance loans and other loans that significantly affect the borrower's or lender's Federal tax liability (discussed in the following paragraphs).

The effects of the first three types of loans on the borrower and lender are summarized in Concept Summary 4.1.

Exceptions and Limitations

No interest is imputed on total outstanding *compensation-related loans* or *corporation-shareholder loans* of $10,000 or less unless the purpose of the loan is tax avoidance.[53] This vague tax avoidance standard exposes practically all compensation-related and corporation-shareholder loans to possible imputed interest problems. Nevertheless, the

[52] § 7872(c).

[53] § 7872(c)(3).



CONCEPT SUMMARY 4.2

Exceptions to the Imputed Interest Rules for Below-Market Loans

Exception	Eligible Loans	Ineligible Loans and Limitations
De minimis—aggregate loans of $10,000 or less	Gift loans	Proceeds used to purchase income-producing assets.
	Employer-employee	Principal purpose is tax avoidance.
	Corporation-shareholder	Principal purpose is tax avoidance.
Aggregate loans of $100,000 or less	Gift loans between individuals	Principal purpose is tax avoidance. For all other loans, interest is imputed to the extent of the borrower's net investment income, if it exceeds $1,000.

$10,000 exception should apply when an employee's borrowing was necessitated by personal needs (e.g., to meet unexpected expenses) rather than tax considerations.

Similarly, no interest is imputed on outstanding *gift loans* of $10,000 or less between individuals, unless the loan proceeds are used to purchase income-producing property.[54] This exemption eliminates from these complex provisions immaterial amounts that do not result in sizable shifts of income.

On loans of $100,000 or less between individuals, the imputed interest cannot exceed the borrower's net investment income for the year (gross income from all investments less the related expenses).[55] Through the gift loan provision, the imputed interest rules are designed to prevent high-income individuals from shifting income to relatives in a lower marginal bracket. This shifting of investment income is considered to occur only to the extent that the borrower also recognizes net investment income. Thus, the income imputed to the lender is limited to the borrower's net investment income.

As a further limitation or exemption, if the borrower's net investment income for the year does not exceed $1,000, no interest is imputed on loans of $100,000 or less. However, these limitations for loans of $100,000 or less do not apply if a principal purpose of a loan is tax avoidance. In such a case, interest is imputed, and the imputed interest is not limited to the borrower's net investment income.[56]

These exceptions to the imputed interest rules are summarized in Concept Summary 4.2.

Vicki made interest-free gift loans as follows.

Borrower	Amount	Borrower's Net Investment Income	Purpose
Susan	$ 8,000	$ –0–	Education
Dan	9,000	500	Purchase of stock
Bonnie	25,000	–0–	Purchase of a business
Olaf	120,000	–0–	Purchase of a residence

Tax avoidance is not a principal purpose of any of the loans. The loan to Susan is not subject to the imputed interest rules because the $10,000 exception applies. The $10,000 exception does not apply to the loan to Dan because the proceeds were used to purchase income-producing assets. However, under the $100,000 exception, the

[54] § 7872(c)(2).

[55] § 7872(d). The $100,000 provision applies only to gift loans.

[56] § 7872(d)(1)(B).

TAX in the NEWS

U.S. Supreme Court Rules on State Taxation of Other States' Interest

Like many other states, Kentucky exempts from taxation interest earned on its own state bonds, but it taxes its own residents on interest income received from bonds issued by other states. A married couple residing in Kentucky challenged the law as unconstitutionally discriminating against interstate commerce by treating Kentucky bonds more favorably than the bonds issued by other states. The U.S. Supreme Court ruled in favor of Kentucky, thus permitting the state (and the 41 other states with similar laws) to tax the out-of-state bond interest while exempting Kentucky bond interest.

Many taxpayers invest in mutual funds that purchase bonds issued by several states. Although the interest from all of the state bonds generally is exempt from Federal income tax, the investor may owe state income tax to the state of residence on the interest received on the bonds of other states. Thus, a bond-oriented mutual fund must inform the investor of the amount of interest income earned from the bonds issued by the various states.

Source: *Department of Revenue of Kentucky v. Davis*, 128 S.Ct. 1801 (USSC, 2008).

imputed interest is limited to Dan's investment income ($500). Since the $1,000 exception also applies to this loan, no interest is imputed.

No interest is imputed on the loan to Bonnie because the $100,000 exception applies. None of the exceptions apply to the loan to Olaf because the loan was for more than $100,000. ■

LO.6

Determine the extent to which receipts can be excluded under the tax benefit rule.

TAX BENEFIT RULE

Generally, if a taxpayer obtains a deduction for an item in one year and in a later year recovers all or a portion of the prior deduction, the recovery is included in gross income in the year received.[57]

EXAMPLE 30

A business deducted as a loss a $1,000 receivable from a customer when it appeared the amount would never be collected. The following year, the customer paid $800 on the receivable. The business must report the $800 as gross income in the year it is received. ■

However, the **tax benefit rule** limits income recognition when a deduction does not yield a tax benefit in the year it is taken. If the taxpayer in Example 30 has no tax liability in the year of the deduction, the $800 receipt is excluded from gross income in the year of the recovery.

EXAMPLE 31

Before deducting a $1,000 loss from an uncollectible business receivable, Tulip Company had taxable income of $200. The business bad debt deduction yields only a $200 tax benefit (assuming no loss carryback is made). That is, taxable income is reduced by only $200 (to zero) as a result of the bad debt deduction. Therefore, if the customer makes a payment on the previously deducted receivable in the following year, only the first $200 is a taxable recovery of a prior deduction. Any additional amount collected is nontaxable because only $200 of the loss yielded a reduction in taxable income (i.e., a tax benefit). ■

LO.7

Understand the Internal Revenue Code provision that excludes interest on state and local government obligations from gross income.

INTEREST ON CERTAIN STATE AND LOCAL GOVERNMENT OBLIGATIONS

At the time the Sixteenth Amendment was ratified by the states, there was some question as to whether the Federal government possessed the constitutional authority to tax interest on state and local government obligations. Taxing such interest was thought to violate the doctrine of intergovernmental immunity because the tax would impair the

[57] § 111(a).

ability of state and local governments to finance their operations.[58] Thus, interest on state and local government obligations was specifically exempted from Federal income taxation.[59] However, the Supreme Court has concluded that there is no constitutional prohibition against levying a nondiscriminatory Federal income tax on state and local government obligations.[60] Nevertheless, the statutory exclusion still exists.

The current exempt status applies solely to state and local government bonds. Thus, income received from the accrual of interest on a condemnation award or an overpayment of state tax is fully taxable.[61] Nor does the exemption apply to gains on the sale of tax-exempt securities.

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft.**



EXAMPLE 11

Macaw Corporation purchases State of Virginia bonds for $10,000 on July 1, 2009. The bonds pay $400 interest each June 30 and December 31. On March 31, 2010, Macaw sells the bonds for $10,500 plus $200 of accrued interest. Macaw recognizes a $500 taxable gain ($10,500 − $10,000), but the $200 accrued interest is exempt from taxation. ■

The interest exclusion reduces the cost of borrowing for state and local governments. A taxpayer with a 35 percent marginal tax rate requires only a 5.2 percent yield on a tax-exempt bond to obtain the same after-tax income as a taxable bond paying 8 percent interest [5.2% ÷ (1 − 0.35) = 8%].

Although the Internal Revenue Code excludes from Federal gross income the interest on state and local government bonds, the interest on U.S. government bonds is not excluded from the Federal tax base. Congress has decided, however, that if the Federal government is not to tax state and local bond interest, the state and local governments are prohibited from taxing interest on U.S. government bonds.[62] While this parity between the Federal and state and local governments exists with regard to taxing each others' obligations, the states are free to tax another's obligations. Thus, some states exempt the interest on the bonds they issue, but tax the interest on bonds issued by other states.

EXAMPLE 12

Aaron is a resident of Virginia. He owns U.S. government bonds that paid him $800 interest during the current year. He also invests in American States Bond Fund, which reports to Aaron that his share of Virginia interest income is $300 and his share of interest income from other states is $600. Aaron includes the $800 in his Federal gross income. Virginia exempts from Virginia taxation the interest on the Virginia bonds, but taxes the interest on bonds issued by other states. Therefore, Aaron includes $600 of interest from other states in his Virginia gross income. ■

Tax Planning Strategies STATE AND MUNICIPAL BONDS

FRAMEWORK FOCUS: INCOME AND EXCLUSION

Strategy: Avoid Income Recognition.

Tax-exempt state and local bonds are almost irresistible investments for taxpayers with high marginal tax rates. To realize the maximum benefit from the exemption, the investor can purchase zero-coupon bonds, which pay interest only at maturity. The advantage of the zero-coupon feature is that the investor can earn tax-exempt interest on

[58] *Pollock v. Farmer's Loan & Trust Co.*, 3 AFTR 2602, 15 S.Ct. 912 (USSC, 1895).
[59] § 103(a).
[60] *South Carolina v. Baker III*, 88–1 USTC ¶9284, 61 AFTR 2d 88–995, 108 S.Ct. 1355 (USSC, 1988).
[61] *Kieselbach v. Comm.*, 43–1 USTC ¶9220, 30 AFTR 370, 63 S.Ct. 303 (USSC, 1943); *U.S. Trust Co. of New York v. Anderson*, 3 USTC ¶1125, 12 AFTR 836, 65 F.2d 575 (CA–2, 1933).
[62] 31 U.S.C.A. § 742.

the accumulated principal and interest. If the investor purchases a tax-exempt bond that pays the interest each year, the interest received may be such a small amount that an additional tax-exempt investment cannot be made. In addition, reinvesting the interest may entail transaction costs (broker's fees). The zero-coupon feature avoids these problems. However, certain state and municipal bond interest may increase the base of the alternative minimum tax, as discussed in Chapter 14.

LO.8

Use the Internal Revenue Code's exclusion of leasehold improvements from gross income.

IMPROVEMENTS ON LEASED PROPERTY

When a real property lease expires, the landlord regains control of both the real property and any improvements to the property (e.g., buildings and landscaping) made by the tenant during the term of the lease. Any improvements made to the leased property are excluded from the landlord's gross income unless the improvement is made to the property in lieu of rent.[63]

EXAMPLE 36

Mahogany Corporation leases office space to Zink and Silver, Attorneys-at-Law. When the law firm took possession of the office space, it added wall partitions, an in-wall computer network, and a variety of other improvements to the space. The improvements were not made in lieu of rent payments to Mahogany. When the lease expires and Mahogany regains possession of the space, the value of the improvements will be excluded from Mahogany's gross income. ■

LO.9

Determine the extent to which life insurance proceeds are excluded from gross income.

LIFE INSURANCE PROCEEDS

General Rule

Life insurance proceeds paid to the beneficiary because of the death of the insured are exempt from income tax.[64] Congress chose to exempt life insurance proceeds from gross income for several reasons, including the following.

- For family members, life insurance proceeds serve much the same purpose as a nontaxable inheritance.
- In a business context (as well as in a family situation), life insurance proceeds replace an economic loss suffered by the beneficiary.

Thus, Congress concluded that, in general, making life insurance proceeds exempt from income tax was a good policy.

EXAMPLE 37

Sparrow Corporation purchased an insurance policy on the life of its CEO and named itself as the beneficiary. Sparrow paid $24,000 in premiums. When the company's CEO died, Sparrow collected the insurance proceeds of $60,000. The $60,000 is excluded from Sparrow's gross income. ■

Exceptions to Exclusion Treatment

The income tax exclusion applies only when the insurance proceeds are received because of the death of the insured. If the owner cancels the policy and receives the cash surrender value, he or she must recognize gain to the extent of the excess of the amount received over the cost of the policy.[65]

Another exception to exclusion treatment applies if the policy is transferred after the insurance company issues it. If the policy is transferred for valuable consideration, the insurance proceeds are includible in the gross income of the transferee to

[63] § 109.

[64] *Estate of D. R. Daly*, 3 B.T.A. 1042 (1926).

[65] *Landfield Finance Co. v. U.S.*, 69–2 USTC ¶9680, 24 AFTR 2d 69–5744, 418 F.2d 172 (CA–7, 1969).

TAX in the NEWS

Corporate-Owned Life Insurance May Not Yield Corporate Benefits

Many corporations purchase insurance policies on the lives of key employees (employees who are extremely important to the company's success, such as the CEO and CFO). The corporation is the beneficiary, and the insurance proceeds are excluded from the corporation's gross income under § 101.

Before changes in the tax laws a decade ago, corporations could deduct the interest on loans to purchase the insurance policies. Many large corporations took advantage of these rules and purchased insurance policies not just on key employees but also on their rank-and-file employees (frequently referred to as "janitor's insurance"), with the corporation as the beneficiary.

In recent years, some heirs of deceased employees who were covered by such janitor's insurance have successfully sued the insurance companies and the employers to recover the insurance proceeds, on the theory that the employer did not have an "insurable interest." Such an interest is required under the laws of most states to prevent individuals from "gambling" on the lives of people in whom they otherwise have no financial interest. The next chapter in this judicial saga will determine whether the heirs who collect the insurance proceeds in this way are "beneficiaries" under § 101.

the extent the proceeds received exceed the amount paid for the policy by the transferee plus any subsequent premiums paid.

Platinum Corporation pays premiums of $5,000 for an insurance policy with a face amount of $12,000 on the life of Beth, an officer of the corporation. Subsequently, Platinum sells the policy to Beth's husband, Jamal, for $5,500. On Beth's death, Jamal receives the proceeds of $12,000. Jamal excludes from gross income $5,500 plus any premiums he paid subsequent to the transfer. The remainder of the proceeds constitutes gross income to Jamal, as he acquired the policy for cash consideration. ■

The Code, however, provides four major exceptions to the consideration rule.[66] These exceptions permit exclusion treatment for transfers to the following parties. The first three exceptions facilitate the use of insurance contracts to fund **buy-sell agreements**.

1. A partner of the insured.
2. A partnership in which the insured is a partner.
3. A corporation in which the insured is an officer or shareholder.
4. A transferee whose basis in the policy is determined by reference to the transferor's basis, such as a gift or a transfer due to a divorce.

Rick and Sam are equal partners who have a buy-sell agreement that allows either partner to purchase the interest of a deceased partner for $500,000. Neither partner has sufficient cash to buy the other partner's interest, but each has a life insurance policy on his own life in the amount of $500,000. Rick and Sam could exchange their policies (usually at little or no taxable gain), and upon the death of either partner, the surviving partner could collect tax-free insurance proceeds. The proceeds then could be used to purchase the decedent's interest in the partnership. ■

Investment earnings arising from the reinvestment of life insurance proceeds generally are subject to income tax. For example, the beneficiary may elect to collect the

[66] § 101(a)(2).

insurance proceeds in installments that include taxable interest income. The interest portion of each installment is included in gross income.



In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

Tax Planning Strategies LIFE INSURANCE

FRAMEWORK FOCUS: INCOME AND EXCLUSION

Strategy: Avoid Income Recognition.

Life insurance is a tax-favored investment. The annual increase in the cash surrender value of the policy is not taxable because it is subject to substantial restrictions (no income has been actually or constructively received). By borrowing on the policy's cash surrender value, the owner can receive the policy's increase in value in cash without recognizing income.

LO.10

Describe the circumstances under which income must be reported from the discharge of indebtedness.

INCOME FROM DISCHARGE OF INDEBTEDNESS

Income is generated when appreciated property is used to pay a debt or when the creditor cancels debt. If appreciated property is used to pay a debt, the transaction is treated as a sale of the appreciated property followed by payment of the debt.[67] Foreclosure by a creditor is also treated as a sale or exchange of the property.[68]

EXAMPLE 11

Juan owed the State Bank $100,000 on an unsecured note. Juan satisfied the note by transferring to the bank common stock with a basis of $60,000 and a fair market value of $100,000. Juan recognizes a $40,000 gain on the transfer. Juan also owed the bank $50,000 on a note secured by land. When Juan's basis in the land was $20,000 and the land's fair market value was $50,000, the bank foreclosed on the loan and took title to the land. Juan recognizes a $30,000 gain on the foreclosure. ■

A creditor may cancel debt to assure the vitality of the debtor. In such cases, the debtor's net worth is increased by the amount of debt forgiven.

EXAMPLE 12

Brown Corporation is unable to meet the mortgage payments on its factory building. Both the corporation and the mortgage holder are aware of the depressed market for industrial property in the area. Foreclosure would only result in the creditor's obtaining unsellable property. To improve Brown's financial position and thus improve its chances of obtaining the additional credit necessary for survival from other lenders, the creditor agrees to forgive all amounts past due and to reduce the principal amount of the mortgage. Brown's net worth is increased by the amount of past due debt that was forgiven *plus* the reduction in the mortgage balance. ■

Generally, the debtor recognizes gross income equal to the amount of debt canceled.[69] The following two examples illustrate additional circumstances where gross income results from cancellation of indebtedness.

[67] Reg. § 1.1001–2(a).

[68] *Estate of Delman v. Comm.*, 73 T.C. 15 (1979).

[69] § 61(a)(12).

EXAMPLE 42

A corporation issues bonds with a face value of $500,000. Subsequently, the corporation repurchases the bonds in the market for $150,000. It has effectively canceled its $500,000 debt with a $150,000 payment, so it recognizes $350,000 in gross income.[70] ■

EXAMPLE 43

Turquoise Corporation borrowed $60,000 from National Bank to purchase a warehouse. Turquoise agreed to make monthly principal and interest payments for 15 years. The interest rate on the note was 4%. When the balance on the note had been reduced through monthly payments to $48,000, the bank offered to accept $45,000 in full settlement of the note. The bank made the offer because interest rates had increased to 7%. Turquoise accepted the bank's offer. As a result, Turquoise recognizes $3,000 ($48,000 – $45,000) of gross income.[71] ■

Though discharge of indebtedness generally increases the taxpayer's gross income, in the following cases, the reduction in debt is excluded from gross income.[72]

1. Creditors' gifts.
2. Discharges under Federal bankruptcy law.
3. Discharges that occur when the debtor is insolvent.
4. Discharge of the farm debt of a solvent taxpayer.
5. Discharge of **qualified real property business indebtedness**.
6. A seller's cancellation of a buyer's indebtedness.
7. A shareholder's cancellation of a corporation's indebtedness.
8. Forgiveness of certain loans to students.
9. Discharge of indebtedness on the taxpayer's principal residence that occurs between January 1, 2007 and January 1, 2013, and is the result of the financial condition of the debtor.

Creditors' Gifts

If the creditor reduces the debt as an act of *love, respect, or generosity*, the debtor has simply received a nontaxable gift (situation 1). Such motivations generally arise only on loans between friends or family members. Rarely will a gift be found to have occurred in a business context. A businessperson may settle a debt for less than the amount due, but only as a matter of business expediency (e.g., high collection costs or disputes as to contract terms) rather than generosity.[73]

Insolvency and Bankruptcy

Cancellation of indebtedness income is excluded when the debtor is insolvent (i.e., the debtor's liabilities exceed the fair market value of the assets) or when the cancellation of debt results from a bankruptcy proceeding (situations 2 and 3). The insolvency exclusion is limited to the amount of insolvency. The tax law permits this exclusion to avoid imposing undue hardship on the debtor (wherewithal to pay) and the debtor's limited resources.

The law imposes a cost for the insolvency and bankruptcy exclusion. More specifically, the debtor must decrease certain tax benefits (capital loss carryforwards, net operating loss carryforwards, some tax credits, and suspended passive losses)[74] by the amount of income excluded. In addition, if the amount of excluded income exceeds these tax benefits, the debtor must then reduce the basis in assets.[75] Thus, excluded cancellation of indebtedness income either accelerates recognition of

[70] See *U.S. v. Kirby Lumber Co.*, 2 USTC ¶814, 10 AFTR 458, 52 S.Ct. 4 (USSC, 1931).

[71] Rev.Rul. 82–202, 1982–1 C.B. 35.

[72] §§ 108 and 1017.

[73] *Comm. v. Jacobson*, 49–1 USTC ¶9133, 37 AFTR 516, 69 S.Ct. 358 (USSC, 1949).

[74] See Chapter 6 for a discussion of net operating loss carryforwards and suspended passive losses. Chapter 8 discusses capital loss carryforwards. Chapter 14 discusses tax credits.

[75] § 108(b).

TAX in the NEWS

Is It an Appropriate Time to Tax?

Many homeowners across the country experienced trauma from the inability to make the mortgage payments on their personal residence (i.e., the subprime mortgage debacle). Some financial institutions agreed to reduce the debt to an amount at which the homeowner could pay the scheduled mortgage amount. But then the financial institution would send the homeowner a Form 1099 advising him or her that the reduction in the debt created gross income.

Often the reason the mortgage holder was willing to reduce the debt was that the foreclosure value of the property was less than the amount of the debt. Thus, the homeowner recognized a taxable gain even though his or her net worth had decreased because the decline in the value of the residence was greater than the debt reduction. Was this an appropriate time to levy an income tax?

Fortunately, Congress concluded that the mortgage reduction under these circumstances should not trigger an income tax. So the Code was amended to exempt such homeowners from this gain resulting from the debt discharge.

future income (by reducing tax benefit carryforwards) or is deferred until the debtor's assets are sold (or depreciated).

EXAMPLE 43

Before any debt cancellation, Maroon Corporation has assets with a fair market value of $500,000 and liabilities of $600,000. A creditor agrees to cancel $125,000 of liabilities. Maroon excludes $100,000 of the debt cancellation income (the amount of insolvency) and is taxed on $25,000. Maroon also reduces any tax benefits and the basis of its assets by $100,000 (the excluded income). ■

Qualified Real Property Indebtedness

Taxpayers (other than C corporations) can elect to exclude income from cancellation of indebtedness if the canceled debt is secured by real property used in a trade or business (situation 5). In addition, the debt must have been used to acquire or improve real property in a trade or business to qualify for the exclusion.[76] The amount of the exclusion is limited to the *lesser of* (1) the excess of the debt over the fair market value of the real property or (2) the adjusted basis of all depreciable real property held. In addition, the basis of all depreciable real property held by the debtor is reduced by the excluded amount.

EXAMPLE 44

Blue, Inc., owns a warehouse worth $5 million, with a $3 million basis. The warehouse is subject to a $7 million mortgage that was incurred in connection with the acquisition of the warehouse. In lieu of foreclosure, the lender decides that it will reduce the mortgage to $4.5 million. Blue may elect to exclude $2 million from gross income ($7 million – $5 million). If Blue makes the election, it reduces the aggregate basis of its depreciable realty by $2 million.

If the basis of the warehouse had been $1 million, and the warehouse was the only piece of depreciable realty that Blue owned, only $1 million of the debt cancellation income would be excluded. ■

Seller Cancellation

When a seller of property cancels debt previously incurred by a buyer in a purchase transaction, the cancellation generally is not treated as income to the buyer (situation 6). Instead, the reduction in debt is considered to be a reduction in the purchase price of the asset. Consequently, the basis of the asset is reduced in the hands of the buyer.[77]

[76] § 108(a)(1)(D).

[77] § 108(e)(5).

TAX in the NEWS

One Way to Avoid Bankruptcy

Many businesses rely heavily on debt obligations (e.g., notes, bonds) to finance their operations. If these obligations come due when other credit sources are scarce and refinancing is not possible, the debtor's default could lead to bankruptcy. To avoid bankruptcy, the debtor may be able to purchase the obligation at a discount. Unfortunately, the discount component constitutes forgiveness of debt and generates gross income to the debtor.

Congress recognized this problem and the tax law provides some relief to the business debtor. For repurchases of debt after 2008, and before 2011, the debtor may defer income recognition to 2014. Even better, such recognition then can be spread over five years. Evidently, Congress is trying to provide the tax incentive that will encourage the repurchase option and discourage massive numbers of bankruptcy, especially in the housing and financial sectors.

EXAMPLE 31

Snipe, Inc., purchases a truck from Sparrow Autos for $10,000 in cash and a $25,000 note payable. Two days after the purchase, Sparrow announces a sale on the same model truck, with a sales price of $28,000. Snipe contacts Sparrow and asks to be given the sales price on the truck. Sparrow complies by canceling $7,000 of the note payable. The $7,000 is excluded from Snipe's gross income, and the basis of the truck to Snipe is $28,000. ■

Shareholder Cancellation

If a shareholder cancels the corporation's indebtedness to him or her (situation 7) and receives nothing in return, the cancellation usually is considered a contribution of capital to the corporation by the shareholder. Thus, the corporation recognizes no income. Instead, its paid-in capital is increased, and its liabilities are decreased by the same amount.[78]

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

7 DIGGING DEEPER

Student Loans

Many states make loans to students on the condition that the loan will be forgiven if the student practices a profession in the state upon completing his or her studies. The amount of the loan that is forgiven (situation 8) is excluded from gross income.[79]

GAINS AND LOSSES FROM PROPERTY TRANSACTIONS

LO.11

Describe the general tax consequences of property transactions.

General Rules

When property is sold or otherwise disposed of, gain or loss may result. Such gain or loss has an effect on the gross income of the party making the sale or other disposition when the gain or loss is *realized* and *recognized* for tax purposes. The concept of realized gain or loss is expressed as follows.

Amount realized from the sale − **Adjusted basis of the property** = **Realized gain (or loss)**

The *amount realized* is the selling price of the property less any costs of disposition (e.g., brokerage commissions) incurred by the seller. The *adjusted basis* of the property is determined as follows.

[78] § 108(e)(6).

[79] § 108(f).

Cost (or other original basis) at date of acquisition[80]	
Add:	**Capital additions**
Subtract:	**Depreciation (if appropriate) and other capital recoveries (see Chapter 5)**
Equals:	**Adjusted basis at date of sale or other disposition**

Without realized gain or loss, generally, there can be no recognized (taxable) gain or loss. All realized gains are recognized unless some specific part of the tax law provides otherwise. Realized losses may or may not be recognized (deductible) for tax purposes, depending on the circumstances involved. For example, losses realized from the disposition of personal-use property (property held by individuals and not used for business or investment purposes) are not recognized.

EXAMPLE 41

During the current year, Ted sells his sailboat (adjusted basis of $4,000) for $5,500. Ted also sells one of his personal automobiles (adjusted basis of $8,000) for $5,000. Ted's realized gain of $1,500 from the sale of the sailboat is recognized. The $3,000 realized loss on the sale of the automobile, however, is not recognized. Thus, the gain is taxable, but the loss is not deductible. ■

Once it has been determined that the disposition of property results in a recognized gain or loss, the next step is to classify the gain or loss as capital or ordinary. Although ordinary gain is fully taxable and ordinary loss is fully deductible, the same is not true for capital gains and capital losses.

Capital Gains and Losses

Gains and losses from the disposition of capital assets receive special tax treatment. Capital assets are defined in the Code as any property held by the taxpayer *other than* property listed in § 1221. The list in § 1221 includes, among other things, inventory, accounts receivable, and depreciable property or real estate used in a business. The sale or exchange of assets in these categories usually results in ordinary income or loss treatment (see Chapter 8). The sale of any other asset generally creates a capital gain or loss.

EXAMPLE 42

Cardinal, Inc., owns a pizza parlor. During the current year, Cardinal sells an automobile. The automobile, which had been used as a pizza delivery car for three years, was sold at a loss of $1,000. Because this automobile was a depreciable asset used in its business, Cardinal has an ordinary loss of $1,000, rather than a capital loss. Cardinal also sold securities held for investment during the current year. The securities were sold for a gain of $800. The securities are capital assets. Therefore, Cardinal has a capital gain of $800. ■

Individuals and corporations are taxed differently on capital gains and losses. An individual's *net capital gain* is subject to the following *maximum* tax rates.[81]

	Maximum Rate[82]
Short-term gains (assets held for one year or less)	35%
Long-term gains (assets held for more than one year)	15/0%

A corporation's net capital gain does not receive any beneficial tax treatment.

[80]Cost usually means purchase price plus expenses related to the acquisition of the property and incurred by the purchaser (e.g., brokerage commissions). For the basis of property acquired by gift or inheritance and other basis rules, see Chapter 7.

[81]§ 1(h). Net capital gain is defined in § 1222(11) as the excess of the net long-term capital gain over the net short-term capital loss.

[82]If the taxpayer is in the 10 or 15% tax bracket, the net long-term capital gain is taxed at a 0% tax rate for 2008, 2009, and 2010 (a 5% rate for prior tax years). Certain assets, such as collectibles (e.g., art, antiques, stamps, etc.) and some real estate, receive special treatment. Collectibles gain is taxed at a maximum rate of 28%, and certain real estate gain is taxed at a maximum rate of 25%. See Chapter 8.

The net capital losses of individuals can be used to offset up to $3,000 of ordinary income each year. Any remaining capital loss is carried forward indefinitely until it is exhausted. Corporations may deduct capital losses only to the extent of capital gains. Capital losses of corporations in excess of capital gains may not be deducted against ordinary income. A corporation's unused capital losses can be carried back three years and then carried forward five years to offset capital gains in those years.[83]

Jones has a short-term capital loss of $5,000 during 2010 and no capital gains. If Jones is an individual, she can deduct $3,000 of this amount as an ordinary loss. The remaining $2,000 loss is carried over to 2011 and is carried forward until it is fully deducted.

If Jones is a C corporation, none of the capital loss is deductible in 2010. All of the $5,000 loss is carried back and offset against capital gains in 2007, 2008, and 2009 (generating an immediate tax refund). Any unused capital loss is carried forward and offset against capital gains in 2011 to 2015. ■

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.



REFOCUS ON THE BIG PICTURE

JUST WHAT IS INCLUDED IN GROSS INCOME?

Using the accrual method of accounting, the gross income recognized by Dr. Sid Stevens's corporation would be $485,500. This includes the entire $485,000 of revenue earned from providing services to patients during the year and the $500 of interest income earned on the money market account. The $500 of municipal bond interest is explicitly excluded from gross income by the Internal Revenue Code.

Dr. Stevens's gross income includes $120,000 of salary earned during the year. Even though Dr. Stevens did not cash his December paycheck until January, he is considered to have constructively received the income since it was readily available to him. Dr. Stevens may be able to reduce his taxable income by the imputed interest expense on the below-market loan from his parents. The increase in value on his stock does not result in gross income until he sells the stock and realizes a gain or loss.

What If?

Rather than electing the accrual method, what if Dr. Stevens had chosen to use the cash method of accounting for his business? Using the cash method is acceptable for certain personal service corporations. While using the cash method would reduce the company's gross income from $485,000 to $431,000 ($485,000 amount billed less $54,000 still to be received), this is only part of the picture. Using the cash method also might result also in some of the corporation's expenses not being deducted until they are paid in a future year.

SUGGESTED READINGS

"Delay in Cashing Not Delay in Taxing," *Practical Tax Strategies*, September 2005.

J. R. Pozzuolo, J. H. Smith, and J. S. Pozzuolo, "Structure a Buy-Sell Agreement for Maximum Utility," *Practical Tax Strategies*, October 2009.

Edward J. Roche, "Lease Cancellation Payments Are Capital Gain? Yes! Section 1234A Overturns *Hort*," *Journal of Taxation*, June 2005.

"Tax Consequences of Oprah's 'Favorite Give-Away Ever,'" *Journal of Taxation*, January 2007.

[83] §§ 1211 and 1212.

KEY TERMS

Accounting income, 4–5
Accounting method, 4–7
Accrual method, 4–10
Assignment of income, 4–14
Buy-sell agreements, 4–25
Cash receipts method, 4–8
Claim of right doctrine, 4–10
Constructive receipt, 4–10
Economic income, 4–4
Fruit and tree metaphor, 4–13
Gross income, 4–3
Hybrid method, 4–10
Income, 4–4
Life insurance proceeds, 4–24
Original issue discount, 4–11
Qualified real property business indebtedness, 4–27
Tax benefit rule, 4–22
Taxable year, 4–7

PROBLEMS

ISSUE ID

1. **LO.1** Cecil buys wrecked cars and stores them on his property. Recently, he purchased a 1990 Ford Taurus for $250. If he can sell all of the usable parts, his total proceeds from the Taurus will be over $2,000. As of the end of the year, he has sold only the radio for $50, and he does not know how many, if any, of the remaining parts will ever be sold. What are Cecil's income recognition issues?

2. **LO.1** Determine the taxpayer's current-year (1) economic income and (2) gross income for tax purposes from the following events.
   a. Sue, a coach, was paid $950,000 to terminate her coaching contract.
   b. Elliot, a six-year-old child, was paid $10,000 for appearing in a television commercial. His parents put the funds into a savings account for the child's education.
   c. Valery's land increased in value by $100,000 when he was successful in having the zoning changed from residential to commercial.
   d. Winn purchased a lottery ticket for $5 and won $900,000.
   e. Larry spent $600 to raise vegetables that he and his family consumed. The cost of the vegetables in a store would have been $2,400.

ETHICS AND EQUITY

3. **LO.1** The roof of your corporation's office building recently suffered some damage as the result of a storm. You, the president of the corporation, are negotiating with a carpenter who has quoted two prices for the repair work: $600 if you pay in cash ("folding money") and $700 if you pay by check. The carpenter observes that the IRS can more readily discover his receipt of a check. Thus, he hints that he will report the receipt of the check (but not the cash). The carpenter has a full-time job and will do the work after hours and on the weekend. He comments that he should be allowed to keep all he earns after regular working hours. Evaluate what you should do.

DECISION MAKING

4. **LO.1** Reno works full-time, and his hobby is gardening. He spent $400 on seeds and fertilizer to grow enough vegetables to last him the entire year. Should Reno be required to recognize income equal to the fair market value of the vegetables in excess of their cost?

5. **LO.2** Jared, a self-employed insect exterminator, uses the cash method of accounting to report his income. In December 2010, Jared received a check for $400 from a client. Jared deposited the check near the end of December. In early January 2011, the bank notified him that the check did not clear because of insufficient funds in the customer's account. The bank sent the check through a second time, and it cleared in January 2011. Jared computes his income using his deposit records. Therefore, he included the $400 in his 2010 gross income.
   a. In what year should Jared report the $400 of income?
   b. Why does it matter to Jared whether he reports the income in 2010 or 2011, as long as he actually reports it?

DECISION MAKING

6. **LO.2** The Bonhaus Apartments is a new development and is in the process of structuring its lease agreements. The company would like to set the damage deposits high enough that tenants will keep the apartments in good condition. The company actually is more concerned about such damage than about tenants not paying their rent.
   a. Discuss the tax effects of the following alternatives.
      - $400 damage deposit and $400 rent for the final month of the lease.
      - $800 rent for the final two months of the lease and no damage deposit.
      - $800 damage deposit with no rent prepayment.
   b. Which option do you recommend?

7. **LO.1, 2, 5** A taxpayer is considering three alternative investments of $10,000. The taxpayer is in the 28% marginal tax bracket for ordinary income and 15% for qualifying capital gains and dividends in all tax years. The selected investment will be liquidated at the end of five years. The alternatives are: DECISION MAKING
   a. A taxable corporate bond yielding 6% before tax, and the interest can be reinvested at 6% before tax.
   b. A tax-favored bond that will have a maturity value of $13,070 (a 5.5% before-tax rate of return).
   c. Land that will increase in value.

   The gain on the land will be classified and taxed as a long-term capital gain. The income from the bonds is taxed as ordinary income, but only upon maturity. How much must the land increase in value to yield a greater after-tax return than either of the bonds?

   Compound amount of $1 and compound value of annuity payments at the end of five years are given as:

Interest Rate	$1 Compounded for Five Years	$1 Annuity Compounded for Five Years
6%	$1.34	$5.64
5.50%	1.31	5.58
4.32%	1.24	5.45

8. **LO.1** Determine the taxpayer's gross income for tax purposes in each of the following situations.
   a. Olga, a cash basis taxpayer, traded a corporate bond with accrued interest of $300 for corporate stock with a fair market value of $11,000 at the time of the exchange. Olga's cost of the bond was $10,000. The value of the stock had increased to $12,000 by the end of the year.
   b. Olga needed $10,000 to make a down payment on her house. She instructed her broker to sell some stock to raise the $10,000. Olga's cost of the stock was $3,000. Based on her broker's advice, instead of selling the stock, she borrowed the $10,000 using the stock as collateral for the debt.
   c. Olga's boss gave her two tickets to the Rabid Rabbits rock concert because Olga met her sales quota. At the time that Olga received the tickets, they had a face price of $200 and were selling on eBay for $300 each. On the date of the concert, the tickets were selling for $400 each. Olga and her son attended the concert.

9. **LO.2** Al is a medical doctor who conducts his practice as a sole proprietor. During 2010, he received cash of $250,000 for medical services. Of the amount collected, $45,000 was for services provided in 2009. At the end of 2010, Al held accounts receivable of $60,000, all for services rendered in 2010. In addition, at the end of the year, Al received $12,000 as an advance payment from a health maintenance organization (HMO) for services to be rendered in 2011. Compute Al's gross income for 2010:
   a. Use the cash basis of accounting.
   b. Use the accrual basis of accounting.
   c. Advise Al on which method of tax accounting he should use.

10. **LO.2** Selma operates a contractor's supply store. She maintains her books using the cash method. At the end of the year, her accountant computes her accrual basis income that is used on her tax return. For 2010, Selma had cash receipts of $1.5 million, which included $200,000 collected on accounts receivable from 2009 sales. It also included the proceeds of a $100,000 bank loan. At the end of 2010, she had $400,000 in accounts receivable from customers, all from 2010 sales.
    a. Compute Selma's accrual basis gross receipts for 2010.
    b. Selma paid cash for all of the purchases. The total amount paid for merchandise in 2010 was $1.2 million. At the end of 2009, she had merchandise on hand with a cost of $100,000. At end of 2010, the cost of merchandise on hand was $300,000. Compute Selma's gross income from merchandise sales for 2010.

11. **LO.2** Color Paint Shop, Inc. (459 Ellis Avenue, Harrisburg, PA 17111), is an accrual basis taxpayer that paints automobiles. During the year, the company painted Samuel's car and was to receive a $1,000 payment from his insurance company. Samuel was not COMMUNICATIONS

satisfied with the work, however, and the insurance company refused to pay. In December 2010, Color and Samuel agreed that Color would receive $800 for the work, subject to final approval by the insurance company. In the past, Color had come to terms with customers only to have the insurance company negotiate an even smaller amount. In May 2011, the insurance company reviewed the claim and paid the $800 to Color. An IRS agent thinks that Color should report $1,000 of income in 2010 and deduct a $200 loss in 2011. Prepare a memo to Susan Apple, a tax partner for whom you are working, with the recommended treatment for the disputed income.

ETHICS AND EQUITY

12. **LO.1, 4** Each Saturday morning Ted makes the rounds of the local yard sales. He has developed a keen eye for bargains, but he cannot use all the items he thinks are "real bargains." Ted has found a way to share the benefits of his talent with others. If Ted spots something priced at $40 that he knows is worth $100, for example, he will buy it and list it on eBay for $70.

    Ted does not include his gain in his gross income because he reasons that he is performing a valuable service for others (both the original sellers and the future buyers) and sacrificing profit he could receive. "Besides," according to Ted, "the IRS does not know about these transactions." Should Ted's ethical standards depend on his perception of his own generosity and the risk that his income-producing activities will be discovered by the IRS? Discuss.

ETHICS AND EQUITY

13. **LO.2** Accounting students understand that the accrual method of accounting is superior to the cash method for measuring the income and expenses from an ongoing business for financial reporting purposes. Thus, CPAs advise their clients to use the accrual method of accounting. Yet CPA firms generally use the cash method to prepare their own tax returns. Are the CPAs being hypocritical?

14. **LO.2** Swan Appliance Company, an accrual basis taxpayer, sells home appliances and service contracts. Determine the effects of each of the following transactions on the company's 2010 gross income assuming that the company uses any available options to defer its taxes.
    a. In December 2009, the company received a $1,200 advance payment from a customer for an appliance that Swan special ordered from the manufacturer. The appliance did not arrive from the manufacturer until January 2010, and Swan immediately delivered it to the customer. The sale was reported in 2010 for financial accounting purposes.
    b. In October 2010, the company sold a 6-month service contract for $900. The company also sold a 36-month service contract for $4,860 in July 2010.
    c. On December 31, 2010, the company sold an appliance for $1,200. The company received $500 cash and a note from the customer for $700 and $260 interest, to be paid at the rate of $40 a month for 24 months. Because of the customer's poor credit record, the fair market value of the note was only $600. The cost of the appliance was $750.

ETHICS AND EQUITY

15. **LO.2** Dr. Randolph, a cash basis taxpayer, knows that he will be in a lower marginal tax bracket next year. To take advantage of the expected decrease in his tax rate, Dr. Randolph instructs his office manager to delay filing the medical insurance claims for services performed in November and December until January of the following year. This will assure that the receipts will not be included in his current gross income. Is Dr. Randolph abusing the cash method of accounting rules?

DECISION MAKING

COMMUNICATIONS

16. **LO.2, 3** Your client is a new partnership, Aspen Associates, which is an engineering consulting firm. Generally, Aspen bills clients for services at the end of each month. Client billings are about $50,000 each month. On average, it takes 45 days to collect the receivables. Aspen's expenses are primarily for salary and rent. Salaries are paid on the last day of each month, and rent is paid on the first day of each month. The partnership has a line of credit with a bank, which requires monthly financial statements. These must be prepared using the accrual method. Aspen's managing partner, Amanda Sims, has suggested that the firm should also use the accrual method for tax purposes and thus reduce accounting fees by $600.

    The partners are in the 35% (combined Federal and state) marginal tax bracket. Write a letter to your client explaining why you believe it would be worthwhile for Aspen to file its tax return on the cash basis even though its financial statements are prepared on the accrual basis. Aspen's address is 100 James Tower, Denver, CO 80208.

17. **LO.3** Alva received dividends on her stocks as follows.

Amur Corporation (a French corporation whose stock is traded on an established U.S. securities market)	$55,000
Blaze, Inc., a Delaware corporation	25,000
Grape, Inc., a Virginia corporation	12,000

a. Alva purchased the Grape stock four years ago, and she purchased the Amur stock two years ago. She purchased the Blaze stock 15 days before it went ex-dividend and sold it 20 days later at a $22,000 loss. Alva had no other capital gains and losses for the year. She is in the 35% marginal tax bracket. Compute Alva's tax on her dividend income.

b. Alva's daughter, who is age 25 and who is not Alva's dependent, had taxable income of $10,000, which included $1,000 of dividends on Grape, Inc. stock. The daughter had purchased the stock two years ago. Compute the daughter's tax liability on the dividends.

18. **LO.5** Roy decides to buy a personal residence and goes to the bank for a $150,000 loan. The bank tells him he can borrow the funds at 7% if his father Hal guarantees the debt. Hal owns CDs currently yielding 6%. The Federal rate is 5%. Hal is willing to do either of the following:

DECISION MAKING

- Cash in the CDs and lend Roy the funds at 6% interest.
- Guarantee the loan for Roy.

Hal will consider lending the funds to Roy at an even lower interest rate, depending on the tax consequences. Hal is in the 35% marginal tax bracket. Roy, whose only source of income is his salary, is in the 15% marginal tax bracket. The interest Roy pays on the mortgage will be deductible by him. Considering only the tax consequences, which option will maximize the family's after-tax wealth?

19. **LO.5** Brad is the president of the Yellow Corporation. He and other members of his family control the corporation. Brad has a temporary need for $50,000, and the corporation has excess cash. He could borrow the money from a bank at 9%, and Yellow is earning 6% on its temporary investments. Yellow has made loans to other employees on several occasions. Therefore, Brad is considering borrowing $50,000 from the corporation. He will repay the loan principal in two years plus interest at 5%. Identify the relevant tax issues for Brad and Yellow Corporation.

ISSUE ID

20. **LO.5** On June 30, 2010, Ridge borrowed $62,000 from his employer. On July 1, 2010, Ridge used the money as follows.

Interest-free loan to Ridge's controlled corporation (operated by Ridge on a part-time basis)	$31,000
Interest-free loan to Tab (Ridge's son)	11,000
National Bank of Grundy 5% CD ($14,700 due at maturity, June 30, 2011)	14,000
National Bank of Grundy 5.5% CD ($6,678 due at maturity, June 30, 2012)	6,000
Total loan proceeds	$62,000

Ridge's employer did not charge him interest. The applicable Federal rate was 5% throughout the relevant period. Tab had investment income of $800 for the year, and he used the loan proceeds to pay medical school tuition. There were no other outstanding loans between Ridge and Tab. What are the effects of the preceding transactions on Ridge's 2010 taxable income?

21. **LO.5** Indicate whether the imputed interest rules apply in the following situations.

a. Mike loaned his sister $90,000 to buy a new home. Mike did not charge interest on the loan. The Federal rate was 5%. Mike's sister had $900 of investment income for the year.

b. Sam's employer maintains an emergency loan fund for its employees. During the year, Sam's wife was very ill, and he incurred unusually large medical expenses. He borrowed $8,500 from his employer's emergency loan fund for six months. The Federal rate was 5.5%. Sam and his wife had no investment income for the year.

c. Jody borrowed $25,000 from her controlled corporation for six months. She used the funds to pay her daughter's college tuition. The corporation charged Jody 4% interest. The Federal rate was 5%. Jody had $3,500 of investment income for the year.
d. Kait loaned her son, Jake, $60,000 for six months. Jake used the $60,000 to pay off college loans. The Federal rate was 5%, and Kait did not charge Jake any interest. Jake had dividend and interest income of $2,100 for the tax year.

22. **LO.5** Vito is the sole shareholder of Vito, Inc. The corporation also employs him. On June 30, 2010, Vito borrowed $8,000 from Vito, Inc., and on July 1, 2011, he borrowed an additional $4,000. Both loans were due on demand. No interest was charged on the loans, and the Federal rate was 8% for all relevant dates. Vito used the money to purchase a boat, and he recognized $1,100 of investment income. Determine the tax consequences to Vito and Vito, Inc., if:
a. The loans are considered employer-employee loans.
b. The loans are considered corporation-shareholder loans.

23. **LO.6** How does the tax benefit rule apply in the following cases?
a. In 2008, the Lemon Furniture Store, an accrual method taxpayer, sold furniture on credit for $1,000 to Sammy. The cost of the furniture was $600. In 2009, Lemon took a bad debt deduction for the $1,000. Lemon was in the 15% marginal tax bracket in 2009. In 2010, Sammy inherited some money and paid Lemon the $1,000. Lemon was in the 35% marginal tax bracket in 2010.
b. In 2009, Marvin, a cash basis taxpayer, took a $2,000 itemized deduction for state income taxes paid. This increased his itemized deductions to a total that was $1,500 more than the standard deduction. In 2010, Marvin received a $2,200 refund when he filed his 2009 state income tax return. Marvin was in the 35% marginal tax bracket in 2009, but was in the 15% marginal tax bracket in 2010.
c. In 2009, Barb, a cash basis taxpayer, was in an accident and incurred $7,000 in medical expenses, which she claimed as an itemized deduction for medical expenses. Because of the 7.5%-of-AGI reduction, the expense reduced her taxable income by only $5,000. In 2010, Barb collected $15,000 from the person who caused the accident that resulted in her personal injury. Barbara was in the 15% marginal tax bracket in both 2009 and 2010.

24. **LO.6** Determine Hazel's gross income from the following receipts for the year.

Gain on sale of Augusta County bonds	$600
Interest on U.S. government savings bonds	300
Interest on state income tax refund	150
Interest on Augusta County bonds	900

DECISION MAKING

25. **LO.7** Tedra, a C corporation, is in the 35% marginal tax bracket, is very risk adverse, and is considering purchasing U.S. government bonds due in 10 years that yield 5.6% before tax. Triple A rated State of Virginia bonds due in 10 years yield 4%. Which is the better alternative, assuming the bonds are of equal risk?

DECISION MAKING

26. **LO.7** Tonya, a Virginia resident, inherited a $10,000 State of Virginia bond in 2010. Her marginal Federal tax rate is 15%, and her marginal state tax rate is 5%. The Virginia bond pays 4% interest, which is not subject to Virginia income tax. Alternatively, Tonya can purchase a corporate bond of comparable risk that will yield 6.5% or a U.S. government bond that pays 6% interest. Tonya does not itemize her deductions. Which investment will provide the greatest after-tax yield?

DECISION MAKING

27. **LO.9** The Egret Company, which has a 40% (combined Federal and state) marginal tax rate, estimated that if its current president should die, the company would incur $200,000 in costs to find a suitable replacement. In addition, profits on various projects the president is responsible for would likely decrease by $300,000. The president has recommended that Egret purchase a $500,000 life insurance policy. How much insurance should the company carry on the life of its president to compensate for the after-tax loss that would result from the president's death, assuming the $200,000 costs of finding a president are deductible and the lost profits would have been taxable?

28. **LO.9** Fay and Edward are partners in an accounting firm. The partners have entered into an arm's length agreement requiring Fay to purchase Edward's partnership interest from Edward's estate if he dies before Fay. The price is set at 150% of the book value of

Edward's partnership interest at the time of his death. Fay purchased an insurance policy on Edward's life to fund this agreement. After Fay had paid $45,000 in premiums, Edward was killed in an automobile accident, and Fay collected $1.75 million of life insurance proceeds. Fay used the life insurance proceeds to purchase Edward's partnership interest.

a. What amount should Fay include in her gross income from receiving the life insurance proceeds?
b. The insurance company paid Fay $20,000 interest on the life insurance proceeds during the period Edward's estate was in administration. During this period, Fay had left the insurance proceeds with the insurance company. Is this interest taxable?
c. When Fay purchased Edward's partnership interest for $1.75 million, as determined by specifications in the agreement, the fair market value of Edward's interest was $2 million. How much should Fay include in her gross income from this bargain purchase?

29. **LO.10** Robin, who was experiencing financial difficulties, was able to adjust his debts as follows. Determine the tax consequences to Robin.
a. Robin's father Willie agreed to cancel a $10,000 debt. Willie told him, "I am not going to treat you any better than I treat your brothers and sister; therefore, the $10,000 is coming out of your inheritance from me."
b. The Land Company, which had sold land to Robin for $80,000, reduced the mortgage on the land by $12,000.
c. The Subprime Bank reduced the principal of the mortgage on his principal residence by $9,000.

30. **LO.10** Hawk Industries, Inc., has experienced financial difficulties as a result of its struggling business. The corporation has been behind on its mortgage payments for the last six months. The mortgage holder has offered to accept $80,000 in full payment of the $100,000 owed on the mortgage and payable over the next 10 years. The interest rate of the mortgage is 7%, and the market rate is now 8%. What tax issues are raised by the creditor's offer?

ISSUE ID

31. **LO.9** Laura recently was diagnosed with cancer and has begun chemotherapy treatments. A cancer specialist has given Laura less than one year to live. She has incurred sizable medical bills and other general living expenses and is in need of cash. Therefore, Laura is considering selling stock that cost her $35,000 and now has a fair market value of $50,000. This amount would be sufficient to pay her medical bills. However, she has read about a company (the Vital Benefits Company) that would purchase her life insurance policy for $50,000. She has paid $30,000 in premiums on the policy.
a. Considering only the tax effects, would selling the stock or selling the life insurance policy result in more beneficial tax treatment?
b. Assume that Laura is a dependent child and that her mother owns the stock and the life insurance policy, which is on the mother's life. Which of the alternative means of raising the cash would result in more beneficial tax treatment?

CRITICAL THINKING

DECISION MAKING

32. **LO.11** During the year, Olivia had the following transactions involving capital assets.

CRITICAL THINKING

Gain on the sale of unimproved land (held as an investment for 4 years)	$ 4,000
Loss on the sale of a camper (purchased 2 years ago and used for family vacations)	(5,000)
Loss on the sale of IBM stock (purchased 9 months ago as an investment)	(1,000)
Gain on the sale of a fishing boat and trailer (acquired 11 months ago at an auction and used for recreational purposes)	2,000

a. If Olivia is in the 33% bracket, how much income tax results?
b. If Olivia is in the 15% bracket, how much income tax results?

33. **LO.11** Andy had the following gains and losses from the sale of capital assets.

CRITICAL THINKING

Loss on Pigeon Corporation stock (held 9 months)	($14,000)
Gain on painting (held for 2 years as an investment)	5,000
Gain on unimproved land (held for 3 years as an investment)	3,000

a. If Andy is in the 35% tax bracket, determine the tax consequences of these transactions.
b. What if Andy is in the 15% tax bracket?
c. What if Andy is a C corporation in the 35% tax bracket?

CRITICAL THINKING

34. **LO.11** Liz and Doug were divorced on July 1 of the current year after 10 years of marriage. Their current year's income received before the divorce included:

Doug's salary	$41,000
Liz's salary	55,000
Rent on apartments purchased by Liz 15 years ago	8,000
Dividends on stock Doug inherited from his mother 4 years ago	1,900
Interest on a savings account in Liz's name funded with her salary	2,400

Allocate the income to Liz and Doug assuming they live in:

a. California.
b. Texas.

CRITICAL THINKING

COMMUNICATIONS

35. **LO.1, 11** In a two-page paper, evaluate the following alternative proposals for taxing the income from property.

a. All assets would be valued at the end of the year, any increase in value that occurred during the year would be included in gross income, and any decrease in value would be deductible from gross income.
b. No gain or loss would be recognized until the taxpayer sold or exchanged the property.
c. Increases or decreases in the value of property traded on a national exchange (e.g., the New York Stock Exchange) would be reflected in gross income for the years in which the changes in value occur. For all other assets, no gain or loss would be recognized until the owner disposes of the property.

Bridge DISCIPLINE

1. Using an online research service, find the audited financial statements of a major U.S. corporation.
   a. Summarize its most important financial accounting policies.
   b. Describe two elements of the Federal income tax law that significantly affected the corporation's earnings per share for the operating year.
2. For the same corporation, summarize three key tax accounting applications, and point out how they differ from book income principles.
3. The exclusion of state and local bond interest from Federal income tax often is criticized as creating a tax haven for the wealthy. Critics, however, often fail to take into account the effect of market forces. In recent months, the long-term tax-exempt interest rate has been 4.45%, while the long-term taxable rate for bonds of comparable risk was approximately 5.4%. On the other hand, state and local governments do enjoy a savings in interest costs because of the tax-favored status of their bonds.

   To date, Congress has concluded that the benefits gained by the states and municipalities and their residents, such as the access to capital and the creation of jobs to construct and maintain critical infrastructure, outweigh any damages to our progressive income tax system. Do you agree with the proponents of the exclusion? Why or why not?

RESEARCH PROBLEMS

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COMMUNICATIONS

Research Problem 1. Tranquility Funeral Home, Inc., your client, is an accrual basis taxpayer that sells "pre-need" funeral contracts. Under these contracts, the customer pays in advance for goods and services to be provided at the contract beneficiary's death. These payments are refundable at the contract purchaser's request, pursuant to state law, at any

time until the goods and services are furnished. Tranquility, consistent with its financial accounting reporting, includes the payments in income for the year the funeral service is provided.

An IRS agent insists that the contract payments are prepaid income subject to tax in the year of receipt. Your client believes the amounts involved are customer deposits.

Write a letter to Tranquility that contains your advice about how the issue should be resolved. The client's address is 400 Rock Street, Memphis, TN 38152.

Research Problem 2. Your client, the Cheyenne Golf and Tennis Club, requires its newly admitted members to purchase stock in the corporation and to make a deposit of $10,000. The deposit is to be repaid in 30 years, and no interest is charged. Is the deposit subject to the imputed interest rules for below-market loans? Outline the points you intend to make when you call the client back next week.

COMMUNICATIONS

Partial list of research aids:
TAM 9735002.

Research Problem 3. Paul purchased a new automobile and was satisfied with the price he paid for the car. A few days after he purchased the car, however, the manufacturer sent him a $1,500 check. Unknown to Paul at the time of the purchase, he was eligible for a $1,500 rebate from the manufacturer. Paul considers this to be "money that blew in the window," since he purchased the car for what he believed it was worth and the rebate came as a complete surprise to him. Must Paul include the $1,500 in gross income for the year he received it?

Research Problem 4. Kristina soon will graduate from law school with more than $90,000 in student loans. She would like to work as a public defender, but the pay for such a position is not enough to allow her to meet her living expenses and repay the student loans. Kristina's law school offers a "debt forgiveness program" for graduates who enter public service, including working as a public defender. Under the program, the school will pay off the student's debt, but the graduate will owe an equal amount to the program. However, if the graduate remains in public service for at least four years, the debt is forgiven.

COMMUNICATIONS

Kristina would like to know the Federal income tax consequences to her if she decides to utilize this program. Prepare a file memo for Kristina summarizing your findings.



INTERNET *activity*

Use the tax resources of the Internet to address the following questions. Do not restrict your search to the Web, but include a review of newsgroups and general reference materials, practitioner sites and resources, primary sources of the tax law, chat rooms and discussion groups, and other opportunities.

Research Problem 5. Congress cut the individual's tax on dividend income a few years ago. As a result, did U.S. corporations increase their dividend payments? Find two studies addressing this point and summarize the authors' conclusions in an e-mail to your instructor.

COMMUNICATIONS

Research Problem 6. Determine the applicable Federal interest rate as of today for purposes of § 7872 below-market loans.

Research Problem 7. Go to the web page for a securities broker or mutual fund. Use a "calculator" provided there to indicate the following.

Taxable Interest Rate	Your Marginal Tax Rate	Breakeven Exempt Interest Rate
6%	35%	?
6%	15%	?
8%	28%	?
8%	33%	?

Research Problem 8. Find an article about the tax and nontax advantages of a buy-sell agreement and summarize the major points for your classmates in no more than three PowerPoint slides.

COMMUNICATIONS

CHAPTER 5

Business Deductions

LEARNING OBJECTIVES

After completing Chapter 5, you should be able to:

LO.1 Understand the meaning and application of the **ordinary, necessary, and reasonableness requirements** for the deduction of business expenses. **(pp. 5-3 to 5-4)**

LO.2 Describe the cash and accrual **methods of accounting** for business deductions. **(pp. 5-5 to 5-6)**

LO.3 Apply a variety of Internal Revenue Code **deduction disallowance provisions**. **(pp. 5-7 to 5-14)**

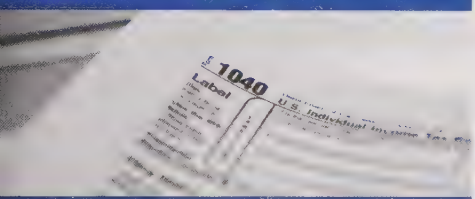
LO.4 Understand the limitations applicable to the **charitable contribution deduction** for corporations. **(pp. 5-14 to 5-17)**

LO.5 Recognize the alternative tax treatments for **research and experimental expenditures** and understand several **other common business deductions**. **(pp. 5-17 to 5-22)**

LO.6 Determine the amount of cost recovery under **MACRS**, and apply the **§ 179 expensing election** and the deduction **limitations on listed property and automobiles** when making the MACRS calculation. **(pp. 5-22 to 5-36)**

LO.7 Identify intangible assets that are eligible for **amortization** and calculate the amount of the deduction. **(pp. 5-36 to 5-37)**

LO.8 Determine the amount of **depletion** expense and recognize the alternative tax treatments for **intangible drilling and development costs**. **(pp. 5-37 to 5-40)**



TAX *Talk*

Last year I had difficulty with my income tax. I tried to take my analyst off as a business deduction. The Government said it was entertainment. We compromised finally and made it a religious contribution.

—Woody Allen

OUTLINE

5.1 Overview of Business Deductions, 5-3
Ordinary and Necessary Requirement, 5-3
Reasonableness Requirement, 5-3
5.2 Timing of Expense Recognition, 5-5
Cash Method Requirements, 5-5
Accrual Method Requirements, 5-6
5.3 Disallowance Possibilities, 5-7
Public Policy Limitations, 5-7
Political Contributions and Lobbying Activities, 5-8
Excessive Executive Compensation, 5-9
Disallowance of Deductions for Capital Expenditures, 5-9
Investigation of a Business, 5-10
Transactions between Related Parties, 5-11
Lack of Adequate Substantiation, 5-13
Expenses and Interest Related to Tax-Exempt Income, 5-13
5.4 Charitable Contributions, 5-14
Property Contributions, 5-15
Limitations Imposed on Charitable Contribution Deductions, 5-16
5.5 Research and Experimental Expenditures, 5-17
Expense Method, 5-17
Deferral and Amortization Method, 5-18
5.6 Other Expense Rules, 5-18
Interest Expense, 5-18
Taxes, 5-19
Domestic Production Activities Deduction, 5-20
5.7 Cost Recovery Allowances, 5-22
Overview, 5-22
Concepts Relating to Depreciation, 5-23
Modified Accelerated Cost Recovery System (MACRS), 5-24
Cost Recovery for Personal Property, 5-24
Cost Recovery for Real Estate, 5-28
Straight-Line Election, 5-29
Farm Property, 5-29
Leasehold Improvement Property, 5-30
Election to Expense Assets under § 179, 5-31
Business and Personal Use of Automobiles and Other Listed Property, 5-32
Alternative Depreciation System (ADS), 5-36
5.8 Amortization, 5-36
5.9 Depletion, 5-37
Intangible Drilling and Development Costs (IDC), 5-38
Depletion Methods, 5-38
5.10 Cost Recovery Tables, 5-40

THE BIG PICTURE Tax Solutions for the Real World

CALCULATION OF DEDUCTIBLE EXPENSES

Dr. Sid Stevens reports the following expense information from his financial reporting system associated with his dental practice. Dr. Stevens operates his business as a corporation with a December 31 year-end, uses the accrual method of accounting, and has $485,500 of gross income.

Salaries and wages (including his own salary of $120,000)	$150,000
Building rent	24,000
Depreciation of dental equipment and office furnishings and equipment*	18,000
Insurance (coverage for malpractice as well as for equipment and office furnishings)	12,000
Utilities	12,000
Taxes and licenses	6,000
Advertising	3,000
Interest expense on loan to buy new equipment	6,000
Charitable contributions	3,000
Political contributions	2,000

*$180,000 of new equipment and furnishings were purchased in January 2010. The financial reporting system depreciation is based on straight-line depreciation over 10 years. The MACRS cost recovery period for tax purposes is 7 years.

Dr. Stevens would like to know the amount of his deductible expenses for tax purposes. **Read the chapter and formulate your response.**

5.1 Overview of Business Deductions

LO.1

Understand the meaning and application of the ordinary, necessary, and reasonableness requirements for the deduction of business expenses.

ORDINARY AND NECESSARY REQUIREMENT

Section 162(a) permits a deduction for all **ordinary and necessary** expenses paid or incurred in carrying on a trade or business. To understand the scope of this provision, it is necessary to understand the meanings of the terms ordinary and necessary.

Neither ordinary nor necessary is defined in the Code or Regulations. However, the courts have had to deal with these terms on numerous occasions and have held that an expense is necessary if a prudent businessperson would incur the same expense and the expense is expected to be appropriate and helpful in the taxpayer's business.[1] Many expenses that are necessary are not ordinary.

EXAMPLE 1

Welch felt that it would be helpful for the development of his new business if he repaid the debts owed by a bankrupt corporation that he had worked for. Consequently, over a period of years, he took a portion of his income and repaid these debts, even though he was under no legal obligation to do so. Welch claimed these repayments as ordinary and necessary business expenses. The Supreme Court indicated that the payments were *necessary* for the development of Welch's business because they contributed toward Welch's reputation and built goodwill. However, the Court also indicated that the expenses were *not ordinary*, since the act of repaying the debts of a bankrupt company was unusual and not a normal method of doing business. Instead, the repayments were more appropriately classified as capital expenditures for goodwill.[2] ■

An expense is ordinary if it is normal, usual, or customary in the type of business conducted by the taxpayer and is not capital in nature.[3] However, an expense need not be recurring to be deductible as ordinary.

EXAMPLE 2

Zebra Corporation engaged in a mail-order business. The post office judged that Zebra's advertisements were false and misleading. Under a fraud order, the post office stamped "fraudulent" on all letters addressed to Zebra's business and returned them to the senders. Zebra spent $30,000 on legal fees in an unsuccessful attempt to force the post office to stop. The legal fees (though not recurring) were ordinary business expenses because they were normal, usual, or customary in the circumstances.[4] ■

REASONABLENESS REQUIREMENT

Although § 162 is intended to allow taxpayers to deduct a broad range of trade or business expenses, certain expenses are mentioned specifically:

- *Reasonable* salaries paid for services.
- Expenses for the use of business property.

The Code applies the **reasonableness requirement** solely to salaries and other compensation for services.[5] However, the courts have held that for *any* business expense to be ordinary and necessary, it must also be reasonable in amount.[6]

What constitutes reasonableness is a question of fact.[7] If an expense is unreasonable, the excess amount is not allowed as a deduction. The question of reasonableness usually arises with respect to closely held corporations with no separation of ownership and management.

Transactions between shareholders and a closely held corporation may result in the disallowance of deductions for excessive salaries, rent, and other expenses paid

[1] *Welch v. Helvering*, 3 USTC ¶1164, 12 AFTR 1456, 54 S.Ct. 8 (USSC, 1933).

[2] *Welch v. Helvering*, 3 USTC ¶1164, 12 AFTR 1456, 54 S.Ct. 8 (USSC, 1933). For a contrasting decision, see *Dunn and McCarthy, Inc. v. Comm.*, 43–2 USTC ¶9688, 31 AFTR 1043, 139 F.2d 242 (CA–2, 1943), involving an *existing* business, where repayments to employees of a bankrupt corporation were held to be both ordinary and necessary.

[3] *Deputy v. DuPont*, 40–1 USTC ¶9161, 23 AFTR 808, 60 S.Ct. 363 (USSC, 1940).

[4] *Comm. v. Heininger*, 44–1 USTC ¶9109, 31 AFTR 783, 64 S.Ct. 249 (USSC, 1943).

[5] § 162(a)(1).

[6] *Comm. v. Lincoln Electric Co.*, 49–2 USTC ¶9388, 38 AFTR 411, 176 F.2d 815 (CA–6, 1949).

[7] *Kennedy, Jr. v. Comm.*, 82–1 USTC ¶9186, 49 AFTR 2d 82–628, 671 F.2d 167 (CA–6, 1982), *rev'g* 72 T.C. 793 (1979).

EXHIBIT 5.1 Partial List of Business Deductions

Advertising	Pension and profit sharing plans
Bad debts	Rent or lease payments
Commissions and fees	Repairs and maintenance
Depletion	Salaries and wages
Depreciation	Supplies
Employee benefit programs	Taxes and licenses
Insurance	Travel and transportation
Interest	Utilities

by the corporation to the shareholders. The courts will view an unusually large salary in light of all relevant circumstances and may find that the salary is reasonable despite its size. If excessive payments for salaries, rent, and other expenses are closely related to the percentage of stock owned by the recipients, the payments are generally treated as dividends.[8] Since dividends are not deductible by the corporation, the disallowance results in an increase in corporate taxable income. Deductions for reasonable salaries will not be disallowed solely because the corporation has paid insubstantial portions of its earnings as dividends to its shareholders.

EXAMPLE 3

Sparrow Corporation, a closely held C corporation, is owned equally by Lupe, Carlos, and Ramon. The company has been highly profitable for several years and has not paid dividends. Lupe, Carlos, and Ramon are key officers of the company, and each receives a salary of $200,000. Salaries for similar positions in comparable companies average only $100,000. Amounts paid the owners in excess of $100,000 may be deemed unreasonable, and, if so, a total of $300,000 in salary deductions by Sparrow is disallowed. The disallowed amounts are treated as dividends rather than salary income to Lupe, Carlos, and Ramon because the payments are proportional to stock ownership. Salaries are deductible by the corporation, but dividends are not. ■

Tax Planning Strategies **UNREASONABLE COMPENSATION**

FRAMEWORK FOCUS: TAX RATE

Strategy: Avoid Double Taxation.

In substantiating the reasonableness of a shareholder-employee's compensation, an internal comparison test is sometimes useful. If it can be shown that nonshareholder-employees and shareholder-employees in comparable positions receive comparable compensation, it is indicative that compensation is not unreasonable.

Another possibility is to demonstrate that the shareholder-employee has been underpaid in prior years. For example, the shareholder-employee may have agreed to take a less-than-adequate salary during the unprofitable formative years of the business. He or she would expect the "postponed" compensation to be paid in later, more profitable years. The agreement should be documented, if possible, in the corporate minutes.

Keep in mind that in testing for reasonableness, the total pay package must be considered. Compensation includes all fringe benefits or perquisites, such as contributions by the corporation to a qualified pension plan, regardless of when the funds are available to the employee.

Common Business Deductions

The language of § 162 is broad enough to permit the deduction of many different types of ordinary and necessary business expenses. Some of the more common deductions are listed in Exhibit 5.1.

[8]Reg. § 1.162–8.

5.2 Timing of Expense Recognition

LO.2

Describe the cash and accrual methods of accounting for business deductions.

A taxpayer's accounting method is a major factor in determining taxable income. The method used determines *when* an item is includible in income and *when* an item is deductible on the tax return. Usually, the taxpayer's regular method of record keeping is used for income tax purposes.[9] The taxing authorities require that the method used clearly reflect income and that items be handled consistently.[10] The most common methods of accounting are the cash method and the accrual method. If a taxpayer owns multiple businesses, it may be possible to use the cash method for some and the accrual method for others.

Throughout the portions of the Code dealing with deductions, the phrase "paid or incurred" is used. A cash basis taxpayer is allowed a deduction only in the year an expense is *paid*. An accrual basis taxpayer is allowed a deduction in the year in which the liability for the expense is *incurred* (becomes certain).

CASH METHOD REQUIREMENTS

The expenses of cash basis taxpayers are deductible only when they are actually paid with cash or other property. Promising to pay or issuing a note does not satisfy the actually paid requirement.[11] However, the payment can be made with borrowed funds. Thus, taxpayers are allowed to claim the deduction at the time they charge expenses on credit cards. They are deemed to have simultaneously borrowed money from the credit card issuer and constructively paid the expenses.[12]

Although the cash basis taxpayer must have actually or constructively paid the expense, payment does not assure a current deduction. The Regulations require capitalization of any expenditure that creates an asset having a useful life that extends substantially beyond the end of the tax year.[13] Thus, cash basis and accrual basis taxpayers cannot take a current deduction for capital expenditures except through amortization, depletion, or depreciation over the tax life of the asset.

EXAMPLE 1

Redbird, Inc., a calendar year and cash basis taxpayer, rents property from Bluejay, Inc. On July 1, 2010, Redbird pays $24,000 rent for the 24 months ending June 30, 2012. The prepaid rent extends 18 months after the close of the tax year—substantially beyond the year of payment. Therefore, Redbird must capitalize the prepaid rent and amortize the expense on a monthly basis. Redbird's deduction for 2010 is $6,000. ■

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.



Tax Planning Strategies **Time Value of Tax Deductions**

FRAMEWORK FOCUS: DEDUCTIONS

Strategy: Accelerate Recognition of Deductions to Achieve Tax Deferral.

Cash basis taxpayers often have the ability to make early payments for their expenses at the end of the tax year. This may permit the payments to be deducted in the year of payment instead of in the following tax year. In view of the time value of money, a tax deduction this year may be worth more than the same deduction next year. Before employing this strategy, the taxpayer must consider next year's expected income and tax rates and whether a cash-flow problem may develop from early payments. Thus, a variety of considerations must be taken into account when planning the timing of tax deductions.

[9] § 446(a).

[10] §§ 446(b) and (e); Reg. § 1.446–1(a)(2).

[11] *Page v. Rhode Island Trust Co., Exr.*, 37–1 USTC ¶9138, 19 AFTR 105, 88 F.2d 192 (CA–1, 1937).

[12] Rev.Rul. 78–39, 1978–1 C.B. 73. See also Rev.Rul. 80–335, 1980–2 C.B. 170, which applies to pay-by-phone arrangements.

[13] Reg. § 1.461–1(a).

ACCRUAL METHOD REQUIREMENTS

The period in which an accrual basis taxpayer can deduct an expense is determined by applying the *all events test* and the *economic performance test.* A deduction cannot be claimed until (1) all the events have occurred to create the taxpayer's liability and (2) the amount of the liability can be determined with reasonable accuracy. Once these requirements are satisfied, the deduction is permitted only if economic performance has occurred. The economic performance test is met only when the service, property, or use of property giving rise to the liability is actually performed for, provided to, or used by the taxpayer.[14]

EXAMPLE 5

On December 22, 2010, Robin, Inc., an entertainment business, sponsored a jazz festival in a rented auditorium at City College. Robin is responsible for cleaning up the auditorium after the festival and for reinstalling seats that were removed so more people could attend the festival. Since the college is closed over the Christmas holidays, the company hired by Robin to perform the work did not begin these activities until January 2, 2011. The cost to Robin is $1,200. Robin cannot deduct the $1,200 until 2011, when the services are performed. ■

As illustrated in Examples 6 and 7, an exception to the economic performance requirement allows some *recurring* items to be deducted if certain conditions are met.[15]



In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

EXAMPLE 6

Towhee Company, an accrual basis, calendar year taxpayer, entered into a monthly maintenance contract during the year. Towhee makes a monthly accrual at the end of every month for this service and pays the fee sometime between the first and fifteenth of the following month when services are performed. The December 2010 accrual is deductible in 2010 even though the service is performed on January 12, 2011. ■

EXAMPLE 7

Tanager, Inc., an accrual basis, calendar year taxpayer, shipped merchandise sold on December 30, 2010, via Greyhound Van Lines on January 2, 2011, and paid the freight charges at that time. Since Tanager reported the sale of the merchandise in 2010, the shipping charge should also be deductible in 2010. This procedure results in a better matching of income and expenses. ■

Reserves for estimated expenses (frequently employed for financial accounting purposes) generally are not allowed for tax purposes because the economic performance test cannot be satisfied.

EXAMPLE 8

Oriole Airlines is required by Federal law to test its engines after 3,000 flying hours. Aircraft cannot return to flight until the tests have been conducted. An unrelated aircraft maintenance company does all of the company's tests for $1,500 per engine. For financial reporting purposes, the company accrues an expense based upon $.50 per hour of flight and credits an allowance account. The actual amounts paid for maintenance are offset against the allowance account. For tax purposes, the economic performance test is not satisfied until the work has been done. Therefore, the reserve method cannot be used for tax purposes. ■

[14] § 461(h).

[15] § 461(h)(3)(A).

TAX in the NEWS

More Prosecutions under the FCPA

The U.S. Justice Department is bringing more prosecutions under the Foreign Corrupt Practices Act (FCPA, 1977) for alleged foreign bribes. Prior to this, the implementation of the Act had remained nearly dormant for several decades.

According to the Justice Department, at least 120 companies are now under investigation. This is an increase from 100 at the end of 2008.

Consequently, U.S. companies with international operations are evaluating whether their activities are at risk under the Act. In situations where violations are apparent, some companies have contacted the Justice Department to "come clean." Although confession is good for the soul, here it is done in the hope that the voluntary disclosure will lessen any penalties imposed.

These investigations and related prosecutions have spawned an army of consultants who specialize in interpreting the FCPA. Some of these consultants are former Justice Department officials who once prosecuted bribery cases for the government.

Source: Adapted from Dionne Searcey, "U.S. Cracks Down on Corporate Bribes," *Wall Street Journal*, May 26, 2009, p. A1.

5.3 Disallowance Possibilities

LO.3

Apply a variety of Internal Revenue Code deduction disallowance provisions.

While most ordinary and necessary business expenses are deductible, the tax law contains provisions that disallow a deduction for certain expenditures. The most frequently encountered disallowance provisions are discussed below.

PUBLIC POLICY LIMITATIONS

Justification for Denying Deductions

The courts developed the principle that a payment that is in violation of public policy is not a necessary expense and is not deductible.[16] Although a bribe or fine may be appropriate, helpful, and even contribute to the profitability of an activity, allowing a deduction for such expenses would frustrate clearly defined public policy. A deduction would effectively represent an indirect governmental subsidy for taxpayer wrongdoing.

Under legislation enacted based on this principle, deductions are disallowed for specific types of expenditures that are considered contrary to public policy:

- Bribes and kickbacks illegal under either Federal or state law, including those associated with Medicare or Medicaid.
- Two-thirds of the treble damage payments made to claimants resulting from violation of antitrust law.[17]
- Fines and penalties paid to a government for violation of law.

EXAMPLE 9

Brown Corporation, a moving company, consistently loads its trucks with weights in excess of the limits allowed by state law. The additional revenue more than offsets the fines levied. The fines are for a violation of public policy and are not deductible. ■

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

3 DIGGING DEEPER

Legal Expenses Incurred in Defense of Civil or Criminal Penalties

To deduct legal expenses as trade or business expenses, the taxpayer must be able to show that the origin and character of the claim are directly related to a trade or business. Personal legal expenses are not deductible. Thus, legal fees incurred in

[16] *Tank Truck Rentals, Inc. v. Comm.*, 58–1 USTC ¶9366, 1 AFTR 2d 1154, 78 S.Ct. 507 (USSC, 1958).

[17] §§ 162(c), (f), and (g).

connection with a criminal defense are deductible only if the crime is associated with the taxpayer's trade or business.[18]

EXAMPLE 10

Debra, a majority shareholder and chief financial officer of Blue Corporation, incurs legal expenses in connection with her defense in a criminal indictment for evasion of Blue's income taxes. Debra may deduct her legal expenses because she is deemed to be in the trade or business of being an executive. The legal action impairs her ability to conduct this business activity.[19] ■

Expenses Related to an Illegal Business

The usual expenses of operating an illegal business (e.g., a numbers racket) are deductible.[20] However, § 162 disallows a deduction for fines, bribes to public officials, illegal kickbacks, and other illegal payments.

EXAMPLE 11

Grizzly, Inc., owns and operates a saloon. In addition, Grizzly operates an illegal gambling establishment out of the saloon's back room. In connection with the illegal gambling activity, Grizzly has the following expenses during the year:

Rent	$ 60,000
Payoffs to police	40,000
Depreciation on equipment	100,000
Wages	140,000
Interest	30,000
Criminal fines	50,000
Illegal kickbacks	10,000
Total	$430,000

All of the usual expenses (rent, depreciation, wages, and interest) are deductible; payoffs, fines, and kickbacks are not deductible. Of the $430,000 spent, $330,000 is deductible and $100,000 is not. ■

An exception applies to expenses incurred in illegal trafficking in drugs.[21] Drug dealers are not allowed a deduction for ordinary and necessary business expenses incurred in their business. In arriving at gross income from the business, however, dealers may reduce total sales by the cost of goods sold.[22]

POLITICAL CONTRIBUTIONS AND LOBBYING ACTIVITIES

Political Contributions

Generally, no business deduction is permitted for direct or indirect payments for political purposes.[23] Historically, the government has been reluctant to extend favorable tax treatment to political expenditures by businesses. Allowing deductions might encourage abuses and enable businesses to have undue influence upon the political process.

Lobbying Expenditures

The Code places severe restrictions on the deductibility of expenses incurred in connection with lobbying activities.[24] These provisions deny deductions for expenditures incurred in connection with:

- influencing state or Federal legislation;
- participating or intervening in any political campaign on behalf of, or in opposition to, any candidate for public office;

[18] *Comm. v. Tellier*, 66–1 USTC ¶9319, 17 AFTR 2d 633, 86 S.Ct. 1118 (USSC, 1966).

[19] Rev.Rul. 68–662, 1968–2 C.B. 69.

[20] *Comm. v. Sullivan*, 58–1 USTC ¶9368, 1 AFTR 2d 1158, 78 S.Ct. 512 (USSC, 1958).

[21] § 280E.

[22] Reg. § 1.61–3(a). Gross income is defined as sales minus cost of goods sold. Thus, while § 280E prohibits any deductions for drug dealers, it does not modify the normal definition of gross income.

[23] § 276.

[24] § 162(e).

- attempting to influence voters with respect to elections, legislative matters, or referendums; and
- attempting to influence the actions of certain high-ranking public officials (including the President, Vice President, and cabinet-level officials).

There are three exceptions to the disallowance provisions. First, an exception is provided for influencing *local* legislation (e.g., city and county governments). Second, the disallowance provision does not apply to activities devoted solely to *monitoring* legislation. Third, a *de minimis* exception allows the deduction of up to $2,000 of annual *in-house expenditures*, if the expenditures are not otherwise disallowed under the provisions discussed above. In-house lobbying expenditures do not include expenses paid to professional lobbyists or any portion of dues used by associations for lobbying. If in-house expenditures exceed $2,000, none of the in-house expenditures can be deducted.

EXAMPLE 12

Egret Company pays a $10,000 annual membership fee to the Free Trade Group, a trade association for plumbing wholesalers. The trade association estimates that 70% of its dues are allocated to lobbying activities. Thus, Egret's deduction is limited to $3,000 ($10,000 × 30%), the amount that is not associated with lobbying activities. ■

EXCESSIVE EXECUTIVE COMPENSATION

The Code contains a *millionaires' provision* that applies to compensation paid by *publicly held* corporations.[25] The provision does not limit the amount of compensation that can be *paid* to an employee. Instead, it limits the amount the employer can *deduct* for the compensation of a covered executive to $1 million annually. Covered employees include the chief executive officer and the four other most highly compensated officers. Employee compensation for this purpose *excludes* the following:

- Commissions based on individual performance.
- Certain performance-based compensation based on company performance according to a formula approved by a board of directors compensation committee (comprised solely of two or more outside directors) and by shareholder vote. The performance attainment must be certified by this compensation committee.
- Payments to tax-qualified retirement plans.
- Payments that are excludible from the employee's gross income (e.g., certain fringe benefits).

Another limitation, which was added by 2008 tax legislation, applies only to covered executives of companies receiving Troubled Asset Relief Program (TARP) assistance. In this case, the deduction for compensation paid to a covered executive is limited to $500,000. The exception for performance-based compensation does not apply to the $500,000 limit. *Covered employees* are somewhat similar to those under the millionaires' provision and include the chief executive officer, the chief financial officer, and the three other most highly compensated officers.

DISALLOWANCE OF DEDUCTIONS FOR CAPITAL EXPENDITURES

The Code specifically disallows a deduction for "any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate."[26] The Regulations further define capital expenditures to include expenditures that add to the value or prolong the life of property or adapt the property to a new or different use.[27] Incidental repairs and maintenance of the property are not capital expenditures and can be deducted as ordinary and necessary business expenses. Repairing a roof is a deductible expense, but replacing a roof is a capital expenditure subject to depreciation deductions over a prescribed period. The tune-up of a delivery truck is an expense; a complete overhaul probably is a capital expenditure.

[25] § 162(m).
[26] § 263(a)(1).
[27] Reg. § 1.263(a)–1(b).

TAX in the NEWS

Recent Inroads on the Deductibility of Executive Compensation

The Emergency Economic Stabilization Act of 2008 established the Troubled Asset Relief Program (TARP) to help bail-out ailing financial institutions. Under TARP, the government is authorized to make direct purchases or sponsored-auction purchases of troubled assets. For the participating companies, standards are set on the deductibility of executive compensation (e.g., for CEOs, CFOs, and other key officers). In direct purchase situations, the IRS is empowered to establish compensation parameters. In auction cases, however, a pay cap of $500,000 is imposed. Also affected are golden parachutes (i.e., severance bonuses paid to executives in change of ownership or control situations).

A last-minute amendment by Senator Christopher Dodd (D-Conn.) imposed even more stringent restrictions on executive bonuses paid by firms receiving Federal aid. Under the provision, a bonus cannot exceed more than one-third of the executive's total annual compensation (e.g., a salary of $1 million would allow a bonus of not more than $500,000—one-third of the salary plus bonus). Further, a "clawback" feature would force a repayment of excessive bonuses previously paid.

Nontax legislation has imposed other limits on compensation that can be paid by TARP recipients. These provisions are being administered by the so-called compensation czar, the Treasury Department's special master for TARP executive compensation. His powers include veto authority over the compensation paid by designated companies that received Federal aid under TARP. He must approve or review the compensation paid to senior executive officers and the 100 highest-paid employees.

Capitalization versus Expense

When an expenditure is capitalized rather than expensed, the deduction is at best deferred and at worst lost forever. Although an immediate tax benefit for a large cash expenditure is lost, the cost may be deductible in increments over a longer period of time.

If the expenditure is for a tangible asset that has an ascertainable life, it is capitalized and may be deducted as depreciation over the life of the asset or as a cost recovery allowance over a specified statutory period under MACRS.[28] Land is not subject to depreciation (or cost recovery) since it does not have an ascertainable life.

EXAMPLE 13

Buffalo Corporation purchases a prime piece of land and an old but usable apartment building located in an apartment-zoned area. Buffalo pays $500,000 for the property and immediately has the building demolished at a cost of $100,000. The $500,000 purchase price and the $100,000 demolition costs must be capitalized, and the tax basis of the land is $600,000. Since land is a nondepreciable asset, no deduction is allowed. ■

INVESTIGATION OF A BUSINESS

Investigation expenses are paid or incurred to determine the feasibility of entering a new business or expanding an existing business. They include such costs as travel, engineering and architectural surveys, marketing reports, and various legal and accounting services. How such expenses are treated for tax purposes depends on a number of variables, including the following:

- The current business, if any, of the taxpayer.
- The nature of the business being investigated.
- Whether or not the acquisition actually takes place.

If the taxpayer is in a business the same as or similar to that being investigated, all investigation expenses are deductible in the year paid or incurred. The tax result is the same whether or not the taxpayer acquires the business being investigated.[29]

[28]Depreciation and cost recovery allowances are discussed later in this chapter.

[29]*York v. Comm.*, 58–2 USTC ¶9952, 2 AFTR 2d 6178, 261 F.2d 421 (CA–4, 1958).

Terry, an accrual basis sole proprietor, owns and operates three motels in Georgia. In the current year, Terry incurs expenses of $8,500 in investigating the possibility of acquiring several additional motels located in South Carolina. The $8,500 is deductible in the current year whether or not Terry acquires the motels in South Carolina. ■

When the taxpayer is not in a business that is the same as or similar to the one being investigated, the tax result depends on whether the new business is acquired. If the business is not acquired, all investigation expenses generally are nondeductible.[30]

Lynn, president and sole shareholder of Marmot Corporation, incurs expenses when traveling from Rochester, New York, to California to investigate the feasibility of acquiring several auto care centers. Marmot is in the residential siding business. If no acquisition takes place, Marmot may not deduct any of the expenses. ■

If the taxpayer is not in a business that is the same as or similar to the one being investigated and actually acquires the new business, the expenses must be capitalized as startup expenses. At the election of the taxpayer, the first $5,000 of the expenses can be immediately deducted. Any excess expenses can be amortized over a period of 180 months (15 years). In arriving at the $5,000 immediate deduction allowed, a dollar-for-dollar reduction must be made for those expenses in excess of $50,000.[31]

Tina, a sole proprietor, owns and operates 10 restaurants located in various cities throughout the Southeast. She travels to Atlanta to discuss the acquisition of an auto dealership. In addition, she incurs legal and accounting costs associated with the potential acquisition. After incurring total investigation costs of $52,000, she acquires the auto dealership on October 1, 2010.

Tina may immediately deduct $3,000 [$5,000 − ($52,000 − $50,000)] and amortize the balance of $49,000 ($52,000 − $3,000) over a period of 180 months. For calendar year 2010, therefore, Tina can deduct $3,817 [$3,000 + ($49,000 × 3/180)]. ■

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

4 DIGGING DEEPER

TRANSACTIONS BETWEEN RELATED PARTIES

The Code places restrictions on the recognition of gains and losses from **related-party transactions**. Without these restrictions, relationships created by birth, marriage, and business would provide endless possibilities for engaging in financial transactions that produce tax savings with no real economic substance or change. For example, to create an artificial loss, a corporation could sell investment property to its sole shareholder at a loss and deduct the loss on the corporate return. The shareholder could then hold the asset indefinitely. Although title to the property has changed, there has been no real economic loss if the shareholder and corporation are considered as an economic unit. A complex set of laws has been designed to eliminate such possibilities.

Losses

The Code provides for the disallowance of any losses from sales or exchanges of property directly or indirectly between related parties.[32] In addition to specified family relationships (e.g., brothers and sisters), certain business relationships are subject to this disallowance rule. For instance, a corporation and a shareholder are considered related parties if the shareholder owns more than 50 percent of the corporation.

[30]Rev.Rul. 57–418, 1957–2 C.B. 143; *Morton Frank*, 20 T.C. 511 (1953); and *Dwight A. Ward*, 20 T.C. 332 (1953).

[31]§ 195(b).

[32]§ 267(a)(1).

When the property is subsequently sold to an unrelated party, any gain recognized is reduced by the loss previously disallowed. Any disallowed loss not used by the related-party buyer to offset his or her recognized gain on a subsequent sale or exchange to an unrelated party is permanently lost.

EXAMPLE 17

Anna, sole shareholder of Leopard Corporation, sells common stock with a basis of $10,000 to the corporation for its fair market value of $8,000. Leopard sells the stock several years later for $11,000. Anna's $2,000 loss is disallowed upon the sale to Leopard, and only $1,000 of gain ($11,000 selling price − $8,000 basis − $2,000 previously disallowed loss) is taxable to Leopard upon the subsequent sale. ■

EXAMPLE 18

George sells common stock with a basis of $10,500 to his wholly owned corporation for its fair market value of $8,000. George's $2,500 loss is disallowed under the related-party rules. The corporation sells the stock eight months later to an unrelated party for $9,000. The corporation's gain of $1,000 ($9,000 selling price − $8,000 basis) is not recognized because of the offset from George's previously disallowed loss of $2,500.

The offset may result in only a partial tax benefit upon the subsequent sale (as in this case). If George had not sold the property to the corporation, he could have recognized a $1,500 loss upon the sale to the unrelated party ($9,000 selling price − $10,500 basis). ■

Unpaid Expenses and Interest

The law prevents related taxpayers from engaging in tax avoidance schemes where one related taxpayer uses the accrual method of accounting and the other uses the cash basis. The accrual basis allows the deduction of expenses when incurred, while the cash method requires that income be reported when received. In the absence of restrictions, an accrual basis, closely held corporation, for example, could borrow funds from a cash basis individual shareholder. At the end of the year, the corporation would accrue and deduct the interest expense, but the cash basis lender would not recognize interest income since no interest had been paid. Section 267 specifically defers the accrual of an interest deduction until the lender is required to include the interest in income; that is, when it is actually received by the cash basis taxpayer. This matching provision also applies to other expenses, such as salaries and bonuses.

The deduction deferral provision does not apply if both of the related taxpayers use the accrual method or both use the cash method. Likewise, it does not apply if the related party reporting income uses the accrual method and the related party taking the deduction uses the cash method.

Relationships and Constructive Ownership

Section 267 operates to disallow losses and defer deductions only between *related parties.* Losses or deductions generated by similar transactions with an unrelated party are allowed. Related parties include the following:

- Brothers and sisters (whether whole, half, or adopted), spouse, ancestors (parents, grandparents), and lineal descendants (children, grandchildren) of the taxpayer.
- A corporation owned more than 50 percent (directly or indirectly) by the taxpayer.
- Two corporations that are members of a controlled group.
- A series of other complex relationships between trusts, corporations, and individual taxpayers.

Constructive ownership provisions are applied to determine whether the taxpayers are related. Under these provisions, stock owned by certain relatives or related entities is deemed to be owned by the taxpayer for purposes of applying the loss and expense deduction disallowance provisions. A taxpayer is deemed to own not only his or her stock but also the stock owned by his or her lineal descendants, ancestors, brothers and sisters or half-brothers and half-sisters, and spouse. The taxpayer is also

deemed to own his or her proportionate share of stock owned by any partnership, corporation, estate, or trust of which he or she is a member. An individual is deemed to own any stock owned, directly or indirectly, by his or her partner. However, constructive ownership by an individual of the other partner's shares does not extend to the individual's spouse or other relatives (i.e., no double attribution).

EXAMPLE 19

The stock of Sparrow Corporation is owned 20% by Ted, 30% by Ted's father, 30% by Ted's mother, and 20% by Ted's sister. On July 1 of the current year, Ted loaned $10,000 to Sparrow Corporation at 8% annual interest, principal and interest payable on demand. For tax purposes, Sparrow uses the accrual basis, and Ted uses the cash basis. Both report on a calendar year basis. Since Ted is deemed to own the 80% owned by his parents and sister, he actually and constructively owns 100% of Sparrow. If the corporation accrues the interest within the taxable year, no deduction can be taken until payment is made to Ted. ■

LACK OF ADEQUATE SUBSTANTIATION

The tax law is built on a voluntary compliance system. Taxpayers file their tax returns, report income and take deductions to which they are entitled, and pay their taxes through withholding or estimated tax payments during the year. The taxpayer has the burden of proof for substantiating expenses deducted on the returns and must retain adequate records. Upon audit, the IRS will disallow any undocumented or unsubstantiated deductions. These requirements have resulted in numerous conflicts between taxpayers and the IRS.

In the case of charitable contributions, Congress has enacted stringent substantiation requirements. All cash contributions, for example, must be supported by receipts (e.g., canceled checks).[33] Single donations of $250 or more of both cash and property require an acknowledgment from the charity. Substantial donations of property (i.e., $500 or more) necessitate the filling of Form 8283 and may have to be supported by appraisals—see Chapter 16 for further details.

EXPENSES AND INTEREST RELATED TO TAX-EXEMPT INCOME

Certain income, such as interest on municipal bonds, is tax-exempt.[34] The law also allows the taxpayer to deduct expenses incurred for the production of income.[35] Deduction disallowance provisions, however, make it impossible to make money at the expense of the government by excluding interest income and deducting interest expense.[36]

EXAMPLE 20

Oriole, Inc., a corporation in the 35% bracket, purchased $100,000 of 6% municipal bonds. At the same time, Oriole used the bonds as collateral on a bank loan of $100,000 at 8% interest. A positive cash flow would result from the tax benefit as follows:

Cash paid out on loan	($8,000)
Cash received from bonds	6,000
Tax savings from deducting interest expense ($8,000 × 35%)	2,800
Net positive cash flow	$ 800

■

To eliminate the possibility illustrated in the preceding example, the Code specifically disallows a deduction for the expenses of producing tax-exempt income. Interest on any indebtedness incurred or continued to purchase or carry tax-exempt obligations also is disallowed.

[33] Rev.Proc. 92–71, 1992–2 C.B. 437, addresses circumstances where checks are not returned by a financial institution or where electronic transfers are made.

[34] § 103.

[35] § 212.

[36] § 265.

Judicial Interpretations

It is often difficult to show a direct relationship between borrowings and investments in tax-exempt securities. Suppose, for example, that a taxpayer borrows money, adds it to existing funds, buys inventory and stocks, then later sells the inventory and buys municipal bonds. A series of transactions such as these can completely obscure any connection between the loan and the tax-exempt investment. One solution would be to disallow interest on any debt to the extent that the taxpayer holds any tax-exempt securities. The law was not intended to go to such extremes. As a result, judicial interpretations have tried to be reasonable in disallowing interest deductions.[37]



In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

EXAMPLE 31

In January of the current year, Crane Corporation borrowed $100,000 at 8% interest. Crane used the loan proceeds to purchase 5,000 shares of stock in White Corporation. In July, Crane sold the stock for $120,000 and reinvested the proceeds in City of Denver bonds, the income from which is tax-exempt. Assuming the $100,000 loan remained outstanding throughout the entire year, Crane cannot deduct the interest attributable to the period when it held the bonds. ■

5.4 Charitable Contributions

LO.4

Understand the limitations applicable to the charitable contribution deduction for corporations.

Corporations and individuals are allowed to deduct contributions made to qualified domestic charitable organizations.[38] Qualified organizations include:[39]

- A state or possession of the United States or any subdivisions thereof.
- A corporation, trust, or community chest, fund, or foundation that is situated in the United States and is organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes or for the prevention of cruelty to children or animals.



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Generally, a deduction for a **charitable contribution** will be allowed only for the year in which the payment is made. However, an important exception is made for *accrual basis* corporations. They may claim the deduction in the year preceding payment if two requirements are met. First, the contribution must be *authorized* by the board of directors by the end of that year. Second, it must be *paid* on or before the fifteenth day of the third month of the following year.

EXAMPLE 32

On December 29, 2010, Blue Company, a calendar year, accrual basis partnership, authorizes a $5,000 donation to the Atlanta Symphony Association (a qualified charitable organization). The donation is made on March 11, 2011. Because Blue Company is a partnership, the contribution can be deducted only in 2011.[40] However, if Blue Company is a corporation and the December 29, 2010 authorization was made by its board of directors, Blue may claim the $5,000 donation as a deduction for calendar year 2010. ■

[37] See, for example, *The Wisconsin Cheeseman, Inc. v. U.S.*, 68–1 USTC ¶9145, 21 AFTR 2d 383, 388 F.2d 420 (CA–7, 1968).

[38] § 170.

[39] § 170(c).

[40] Each calendar year partner will report an allocable portion of the charitable contribution deduction as of December 31, 2011 (the end of the partnership's tax year). See Chapter 11.

PROPERTY CONTRIBUTIONS

The amount that can be deducted for a noncash charitable contribution depends on the type of property contributed. Property must be identified as capital gain property or ordinary income property. **Capital gain property** is property that, if sold, would result in long-term capital gain or § 1231 gain for the taxpayer. Such property generally must be a capital asset and must be held for the long-term holding period (more than one year). **Ordinary income property** is property that, if sold, would *not* result in long-term capital gain or § 1231 gain for the taxpayer. Examples of ordinary income property include inventory and capital assets held short term (one year or less). Refer to Chapter 4 for a brief introduction to the distinction between capital and ordinary assets.

The deduction for a charitable contribution of capital gain property is generally measured by the property's *fair market value.*

EXAMPLE 21

During the current year, Mallard Corporation donates a parcel of land (a capital asset) to Oakland Community College. Mallard acquired the land in 1988 for $60,000, and the fair market value on the date of the contribution is $100,000. The corporation's charitable contribution deduction (subject to a percentage limitation discussed later) is measured by the asset's fair market value of $100,000, even though the $40,000 of appreciation on the land has never been included in Mallard's income. ■

In two situations, a charitable contribution of capital gain property is measured by the basis of the property, rather than fair market value. If a corporation contributes tangible personal property and the charitable organization puts the property to an *unrelated use*, the appreciation on the property is not deductible. Unrelated use is defined as use that is not related to the purpose or function that qualifies the organization for exempt status.

EXAMPLE 22

White Corporation donates a painting worth $200,000 to Western States Art Museum (a qualified charity), which exhibits the painting. White had acquired the painting in 1980 for $90,000. Because the museum put the painting to a related use, White is allowed to deduct $200,000, the fair market value of the painting. ■

EXAMPLE 23

Assume the same facts as in the previous example, except that White Corporation donates the painting to the American Cancer Society, which sells the painting and deposits the $200,000 proceeds in the organization's general fund. White's deduction is limited to the $90,000 basis because it contributed tangible personal property that was put to an unrelated use by the charitable organization. ■

The deduction for charitable contributions of capital gain property to certain private nonoperating foundations (defined in §§ 4942 and 509) is also limited to the basis of the property.

As a general rule, the deduction for a contribution of ordinary income property is limited to the basis of the property. On certain contributions of inventory by *corporations*, however, the amount of the deduction is equal to the lesser of (1) the sum of the property's basis plus 50 percent of the appreciation on the property or (2) twice the property's basis. The following contributions of inventory qualify for this increased contribution amount.

- A contribution of property to a charitable organization for use that is related to the organization's exempt function and such use is solely for the care of the ill, needy, or infants. (Individual taxpayers also qualify for this exception if the property is "wholesome food.")
- A contribution of books to a public school (K through 12) that uses the books in its educational programs.
- A contribution of tangible personal research property constructed by the corporation to a qualified educational or scientific organization that uses

TAX

What Ten Percent Ceiling?

Just how generous is corporate America? Based on recent data, of the nearly $1.3 trillion of corporate income subject to tax, contributions and gifts totaled approximately $14.8 billion. In other words, only about 1 percent of the average corporation's taxable income goes to charity.

Source: 2006 Corporation Returns—Returns of Active Corporations; Table 2—Balance Sheet, Income Statement, and Selected Other Items by Size of Total Assets; 2009.

the property for research or experimentation, or research training. (The property must be contributed within two years from the date of its construction by the donor, and its original use must begin with the donee.)

- A contribution of computer equipment and software to a qualified educational organization or public library that uses the property for educational purposes. (The property must be contributed within three years from the date of its acquisition or construction by the donor, and its original use must begin with the donor or donee.)[41]

EXAMPLE 21

Lark Corporation, a clothing retailer, donates children's clothing to the Salvation Army to be used to attire homeless children. Lark's basis in the clothes is $2,000, and the fair market value (the sales price to customers) is $3,000. Lark's deduction is $2,500 [$2,000 basis + 50% × ($3,000 − $2,000)]. If, instead, the fair market value is $7,000, Lark's deduction is $4,000 (2 × $2,000 basis). ■

LIMITATIONS IMPOSED ON CHARITABLE CONTRIBUTION DEDUCTIONS

Both corporations and individuals are subject to percentage limits on the charitable contribution deduction.[42] The complex limitations for individual taxpayers are covered in Chapter 16.

For any tax year, a corporate taxpayer's contribution deduction is limited to 10 percent of taxable income. For this purpose, taxable income is computed without regard to the charitable contribution deduction, any net operating loss carryback or capital loss carryback, dividends received deduction, and domestic production activities deduction. Any contributions in excess of the 10 percent limitation may be carried forward to the five succeeding tax years. Any carryforward must be added to subsequent contributions and will be subject to the 10 percent limitation. In applying this limitation, the current year's contributions must be deducted first, with carryover amounts from previous years deducted in order of time.[43]

EXAMPLE 22

During 2010, Orange Corporation (a calendar year taxpayer) had the following income and expenses.

Income from operations	$140,000
Expenses from operations	110,000
Dividends received	10,000
Charitable contributions made in May 2010	6,000

[41]These conditions are set forth in §§ 170(e)(3), (4), and (6).

[42]The percentage limitations applicable to individuals and corporations are set forth in § 170(b).

[43]The carryover rules relating to all taxpayers are in § 170(d).

For purposes of the 10% limitation only, Orange Corporation's taxable income is $40,000 ($140,000 − $110,000 + $10,000). Consequently, the allowable charitable contribution deduction for 2010 is $4,000 (10% × $40,000). The $2,000 unused portion of the contribution can be carried forward to 2011, 2012, 2013, 2014, and 2015 (in that order) until exhausted. ■

Assume the same facts as in the previous example. In 2011, Orange Corporation has taxable income (for purposes of the 10% limitation) of $50,000 and makes a charitable contribution of $4,500. The maximum deduction allowed for 2011 is $5,000 (10% × $50,000). The entire 2011 contribution of $4,500 and $500 of the 2010 charitable contribution carryforward are currently deductible. The remaining $1,500 of the 2010 carryforward may be carried over to 2012 (and later years, if necessary). ■

5.5 Research and Experimental Expenditures

LO.5

Recognize the alternative tax treatments for research and experimental expenditures and understand several other common business deductions.

Section 174 covers the treatment of **research and experimental expenditures**. The Regulations define research and experimental expenditures as follows:

> all such costs incident to the development of an experimental or pilot model, a plant process, a product, a formula, an invention, or similar property, and the improvement of already existing property of the type mentioned. The term does not include expenditures such as those for the ordinary testing or inspection of materials or products for quality control or those for efficiency surveys, management studies, consumer surveys, advertising, or promotions.[44]

The law permits three alternatives for the handling of research and experimental expenditures.

- Expense in the year paid or incurred.
- Defer and amortize.
- Capitalize.

If the costs are capitalized, a deduction is not available until the research project is abandoned or is deemed worthless. Since many products resulting from research projects do not have a definite and limited useful life, a taxpayer should ordinarily elect to write off the expenditures immediately or to defer and amortize them. It is generally preferable to elect an immediate write-off of the research expenditures because of the time value of the tax deduction.

The law also provides for a research activities credit. The credit amounts to 20 percent of certain research and experimental expenditures.[45]

EXPENSE METHOD

A taxpayer can elect to expense all of the research and experimental expenditures incurred in the current year and all subsequent years. The consent of the IRS is not required if the method is adopted for the first taxable year in which such expenditures were paid or incurred. Once the election is made, the taxpayer must continue to expense all qualifying expenditures unless a request for a change is made to, and approved by, the IRS. In certain instances, a taxpayer may incur research and experimental expenditures before actually engaging in any trade or business activity. In such instances, the Supreme Court has applied a liberal standard of deductibility and permitted a deduction in the year of incurrence.[46]

[44] Reg. § 1.174–2(a)(1).

[45] § 41. See Chapter 14 for a more detailed discussion of the research activities credit.

[46] *Snow v. Comm.*, 74–1 USTC ¶9432, 33 AFTR 2d 74–1251, 94 S.Ct. 1876 (USSC, 1974).

DEFERRAL AND AMORTIZATION METHOD

Alternatively, research and experimental expenditures may be deferred and amortized if the taxpayer makes an election.[47] Under the election, research and experimental expenditures are amortized ratably over a period of not less than 60 months. A deduction is allowed beginning with the month in which the taxpayer first realizes benefits from the research and experimental expenditures. The election is binding, and a change requires permission from the IRS.

EXAMPLE 21

Gold Corporation decides to develop a new line of adhesives. The project begins in 2010. Gold incurs the following expenses in 2010 and 2011 in connection with the project.

	2010	2011
Salaries	$25,000	$18,000
Materials	8,000	2,000
Depreciation on machinery	6,500	5,700

The benefits from the project will be realized starting in March 2012. If Gold Corporation elects a 60-month deferral and amortization period, there is no deduction prior to March 2012, the month benefits from the project begin to be realized. The deduction for 2012 is $10,867, computed as follows.

Salaries ($25,000 + $18,000)	$43,000
Materials ($8,000 + $2,000)	10,000
Depreciation ($6,500 + $5,700)	12,200
Total	$65,200
$65,200 × (10 months/60 months)	$10,867

■

The option to treat research and experimental expenditures as a deferred expense is usually employed when a company does not have sufficient income to offset the research and experimental expenses. Rather than create net operating loss carryovers that might not be utilized because of the 20-year limitation on such carryovers, the deferral and amortization method may be used. The deferral of research and experimental expenditures should also be considered if the taxpayer expects higher tax rates in the future.

5.6 Other Expense Rules

In addition to the provisions related to charitable contributions and research and experimental expenditures, a variety of other expenses are subject to special rules and limitations. Some of these rules are noted briefly in the paragraphs that follow.

INTEREST EXPENSE

Generally, corporations are not limited in the amount of interest expense they may deduct. However, the deductibility of expenses (including interest) from certain activities may be limited.[48] In contrast, individuals generally may not deduct interest expense on loans used for personal purposes, unless the loan is secured by a home. Furthermore, individuals may only deduct interest expense associated with investments to the extent of net investment income and interest on qualified student loans.[49]

[47] § 174(b)(2).

[48] See, for example, the discussion of the passive activity limits in Chapter 6.

[49] See Chapter 16 for a more detailed discussion of the deductibility of interest by individuals.

Because the deductibility of interest expense associated with certain activities is limited, the IRS provides rules for allocating interest expense among activities. Under these rules, interest is allocated in the same manner as the debt with respect to which the interest is paid, and debt is allocated by tracing disbursements of the debt proceeds to specific expenditures. The interest tracing rules are complex and depend on whether loan proceeds are commingled with other cash and the length of time the loan proceeds are held before they are spent.

TAXES

As with interest expense, tax payments in a business or investment context are generally deductible. However, most Federal taxes are not deductible. Individuals may also deduct tax payments, subject to limitations (discussed in Chapter 16). One unique problem associated with determining the deductibility of taxes relates to real estate taxes paid during a year when the real estate is sold.

Real estate taxes for the entire year are apportioned between the buyer and seller based on the number of days the property was held by each during the real property tax year. This apportionment is required whether the tax is paid by the buyer or the seller or is prorated according to the purchase agreement. It is the apportionment that determines who is entitled to deduct the real estate taxes in the year of sale. The required apportionment prevents the shifting of the deduction for real estate taxes from buyer to seller, or vice versa. In making the apportionment, the assessment date and the lien date are disregarded. The date of sale counts as a day the property is owned by the buyer.

A county's real property tax year runs from January 1 to December 31. Nuthatch Corporation, the owner on January 1 of real property located in the county, sells the real property to Crane, Inc., on June 30. Crane owns the real property from June 30 through December 31. The tax for the real property tax year, January 1 through December 31, is $3,650. Assuming this is not a leap year, the portion of the real property tax treated as imposed upon Nuthatch, the seller, is $1,800 [(180/365) × $3,650, January 1 through June 29], and $1,850 [(185/365) × $3,650, June 30 through December 31] of the tax is treated as imposed upon Crane, the purchaser. ■

If the actual real estate taxes are not prorated between the buyer and seller as part of the purchase agreement, adjustments are required. The adjustments are necessary to determine the amount realized by the seller and the adjusted basis of the property to the buyer. If the buyer pays the entire amount of the tax, it effectively has paid the seller's portion of the real estate tax and has therefore paid more for the property than the actual purchase price. Thus, the amount of real estate tax that is apportioned to the seller (for Federal income tax purposes) and paid by the buyer is added to the buyer's adjusted basis. The seller must increase the amount realized on the sale by the same amount.

Seth sells real estate on October 3 for $100,000. The buyer, Winslow Company, pays the real estate taxes of $3,650 for the calendar year, which is the real estate property tax year. Assuming this is not a leap year, $2,750 (for 275 days) is apportioned to and is deductible by the seller, Seth, and $900 (for 90 days) of the taxes is deductible by Winslow. The buyer has paid Seth's real estate taxes of $2,750 and has therefore paid $102,750 for the property. Winslow's basis is increased to $102,750, and the amount realized by Seth from the sale is increased to $102,750. ■

The opposite result occurs if the seller (rather than the buyer) pays the real estate taxes. In this case, the seller reduces the amount realized from the sale by the amount that has been apportioned to the buyer. The buyer is required to reduce his or her adjusted basis by a corresponding amount.

EXAMPLE 32

Silver Corporation sells real estate to Butch for $100,000 on October 3. While Silver held the property, it paid the real estate taxes of $3,650 for the calendar year, which is the real estate property tax year. Although Silver paid the entire $3,650 of real estate taxes, $900 of that amount is apportioned to Butch, based on the number of days he owned the property, and is therefore deductible by him. The effect is that the buyer, Butch, has paid only $99,100 ($100,000 − $900) for the property. The amount realized by Silver, the seller, is reduced by $900, and Butch reduces his basis in the property to $99,100. ■

DOMESTIC PRODUCTION ACTIVITIES DEDUCTION

The 2004 American Jobs Creation Act replaced certain tax provisions that our world trading partners regarded as allowing unfair advantage to U.S. exports. Among other changes, the Act created a deduction based on the income from U.S. manufacturing activities (designated as *production activities*). The **domestic production activities deduction (DPAD)** is contained in § 199.

Calculation of the Domestic Production Activities Deduction

For tax years beginning in 2010 and thereafter, the DPAD is based on the following formula:[50]

$$9\% \times \text{Lesser of} \begin{cases} \text{Qualified production activities income (QPAI)} \\ \text{Taxable (or modified adjusted gross) income or alternative minimum taxable income} \end{cases}$$

For tax years beginning in 2005 or 2006, the 9 percent factor was 3 percent. For tax years beginning in 2007, 2008, and 2009, the 9 percent factor was 6 percent.

Taxable income is determined without regard to the DPAD. In the case of an individual (a sole proprietorship or an owner of a flow-through entity), **modified adjusted gross income** is substituted for taxable income.[51]

The taxable income limitation is determined after the application of any net operating loss (NOL) deduction for the tax year (NOLs are explained in Chapter 6). Thus, a company with an NOL carryforward for a tax year is ineligible for the DPAD if the carryforward eliminates current taxable income. Further, a taxpayer that has an NOL carryback may lose part or all of the DPAD benefit for that year. As taxable income is reduced by the NOL carryback, there is a corresponding reduction in the DPAD. If qualified production activities income (QPAI) cannot be used in a particular year due to the taxable income limitation (see the above formula), it is lost forever. (The calculation of QPAI is explained in the next section.)

EXAMPLE 33

Opal, Inc., manufactures and sells costume jewelry. It also sells costume jewelry purchased from other manufacturers. During 2010, Opal had a *profit* of $200,000 (QPAI) from the sale of its own manufactured jewelry and a *loss* of $50,000 from the sale of the purchased jewelry. Based on this information, Opal's QPAI is $200,000, and its taxable income is $150,000 ($200,000 − $50,000). Opal's DPAD becomes $13,500 [9% of the lesser of $200,000 (QPAI) or $150,000 (taxable income)]. ■

EXAMPLE 34

Assume the same facts as in Example 33, except that Opal also has an NOL carryover from 2009 of $300,000. As taxable income for 2010 is zero ($200,000 − $50,000 − $300,000), there is no DPAD. ■

[50] § 199(a).

[51] § 199(d)(2). Generally, modified AGI is AGI prior to the effect of § 199.

Another important limitation is that the amount of the DPAD cannot exceed 50 percent of certain **W–2 wages** paid by the taxpayer during the tax year.[52] An employer's W–2 wages include the sum of the aggregate amount of wages and elective deferrals required to be included on the W–2 wage statements for certain employees during the employer's taxable year. Elective deferrals include those amounts deferred under § 457 plans and Roth IRA contributions. An employer previously included wages paid to all workers during a tax year and not just the wages of the employees engaged in qualified production activities. However, as a result of a recent statutory change, an employer is permitted to include only those W–2 wages paid to employees engaged in qualified production activities.

In 2010, Red, Inc., a calendar year taxpayer, has QPAI of $2 million and taxable income of $2.1 million. Since Red outsources much of its work to independent contractors, its W–2 wage base, which for Red is related entirely to production activities, is $80,000. Although Red's DPAD normally would be $180,000 [9% of the lesser of $2 million (QPAI) or $2.1 million (taxable income)], it is limited to $40,000 [50% of $80,000 (W–2 wages)]. ■

Assume the same facts as in Example 35, except that Red also pays salaries of $50,000 related to its *nonproduction* activities. Because these wages are not paid to employees engaged in production activities, the wage limitation on the DPAD remains at $40,000 [50% of $80,000 ($80,000 + $0)]. ■

The purpose of this limitation is to preserve U.S. manufacturing jobs and to discourage their outsourcing.

Calculation of Qualified Production Activities Income

Qualified production activities income (QPAI) is the excess of **domestic production gross receipts (DPGR)** over the sum of:

- The cost of goods sold allocated to such receipts.
- Other deductions, expenses, or losses directly allocated to such receipts.
- The ratable portion of deductions, expenses, and losses not directly allocable to such receipts or another class of income.[53]

QPAI is determined on an item-by-item basis—not on a division-by-division or transaction-by-transaction basis. Because all items must be netted in the calculation, the final QPAI amount can be either positive or negative. The effect of the netting rule is to preclude taxpayers from selecting only profitable product lines or profitable transactions when calculating QPAI.

A taxpayer manufactures pants and shirts with the following QPAI results: $5 for one pair of pants and a negative $2 for one shirt. Because the two items are netted, the QPAI amount that controls is $3 ($5 – $2). ■

Five specific categories of DPGR qualify for the DPAD.[54]

- The lease, license, sale, exchange, or other disposition of qualified production property (QPP) that was manufactured, produced, grown, or extracted (MPGE) in the United States.
- Qualified films largely created in the United States.
- The production of electricity, natural gas, or potable water.
- Construction (but not self-construction) performed in the United States.
- Engineering and architectural services for domestic construction.

[52] § 199(b).
[53] § 199(c).
[54] § 199(c)(4).

TAX

COST RECOVERY BY ANY OTHER NAME

Of the nearly $736 billion of corporate cost recovery deductions claimed in a recent tax year, the use of the three most familiar types of these asset-related tax incentives is shown as follows.

	Percentage of Total Deductions Claimed
Amortization	21.28
Cost recovery or depreciation	76.66
Depletion	2.06
	100.00

Source: 2006 Corporation Returns—Returns of Active Corporations; Table 2—Balance Sheet, Income Statement and Selected Other Items by Size of Total Assets, *IRS Tax Stats.*

The sale of food and beverages prepared by a taxpayer at a retail establishment and the transmission or distribution of electricity, natural gas, or potable water are specifically excluded from the definition of DPGR.

Eligible Taxpayers

The deduction is available to a variety of taxpayers including individuals, partnerships, S corporations, C corporations, cooperatives, estates, and trusts. For a pass-through entity (e.g., partnerships, S corporations), the deduction flows through to the individual owners. In the case of a sole proprietor, a deduction *for* AGI results and is claimed on Form 1040, line 35 on page 1. A Form 8903 must be attached to support the deduction.

5.7 COST RECOVERY ALLOWANCES

LO.6

Determine the amount of cost recovery under MACRS, and apply the § 179 expensing election and the deduction limitations on listed property and automobiles when making the MACRS calculation.

OVERVIEW

Taxpayers may write off the cost of certain assets that are used in a trade or business or held for the production of income. A write-off may take the form of a *cost recovery allowance* (depreciation under prior law), depletion, or amortization. Tangible assets, other than natural resources, are written off through cost recovery allowances. Natural resources, such as oil, gas, coal, and timber, are *depleted.* Intangible assets, such as copyrights and patents, are *amortized.* Generally, no write-off is allowed for an asset that does not have a determinable useful life.

The tax rules for writing off the cost of business assets differ from the accounting rules. Several methods are available for determining depreciation for accounting purposes, including the straight-line, declining-balance, and sum-of-the-years' digits methods. Historically, *depreciation* for tax purposes was computed using variations of these accounting methods. Congress completely overhauled the **depreciation rules** in 1981 tax legislation by creating the **accelerated cost recovery system (ACRS).** Substantial modifications were made to ACRS in 1986 tax legislation, resulting in the **modified accelerated cost recovery system (MACRS)** replacing ACRS.

The statutory changes that have taken place since 1980 have widened the gap that exists between the accounting and tax versions of depreciation. The tax rules that



BRIDGE TO FINANCE

For many business entities, success in producing goods for sale is dependent on the efficient use of fixed assets, such as machinery and equipment. An important question for such businesses to resolve is how they should gain access to the required complement of fixed assets: that is, whether the assets should be purchased or leased. To answer this question, the taxpayer must determine which alternative is more cost-effective. Critical to this assessment is quantifying the after-tax cost (including the associated tax benefits) of each option.

Purchasing productive assets for business use often necessitates an immediate cash outflow. However, the tax savings resulting from the available depreciation expense deductions mitigate the impact of that outflow, by reducing the taxpayer's taxable income and the income tax paid for the year. Consequently, the tax savings from the depreciation calculation associated with the purchase of an asset reduce the after-tax cost of employing the asset. The analysis can be refined further by evaluating the tax savings from the depreciation deductions in present value terms by quantifying the tax savings from the depreciation expense over the life of the asset. The asset's purchase also can be financed with debt.

Taxpayers who lease rather than buy an asset benefit by not giving up the use of funds that otherwise would have gone to purchase the asset. Lessees also forgo the opportunity to claim depreciation deductions; however, they reduce the cost of the leasing option by claiming the lease expense as a deduction against their tax base.

existed prior to 1981 were much more compatible with generally accepted accounting principles. This chapter focuses on the MACRS rules because they cover more recent property acquisitions (i.e., after 1986) and their use is widespread.

CONCEPTS RELATING TO DEPRECIATION

Nature of Property

Property includes both realty (real property) and personalty (personal property). *Realty* generally includes land and buildings permanently affixed to the land. *Personalty* is defined as any asset that is not realty. Personalty includes furniture, machinery, equipment, and many other types of assets. Do not confuse personalty (or personal property) with personal-use property. Personal-use property is any property (realty or personalty) that is held for personal use rather than for use in a trade or business or an income-producing activity. Cost recovery is not allowed for personal-use assets.

In summary, both realty and personalty can be either business-use/income-producing property or personal-use property. Examples include a residence (realty that is personal use), an office building (realty that is business use), a dump truck (personalty that is business use), and regular wearing apparel (personalty that is personal use). It is imperative that this distinction between the classification of an asset (realty or personalty) and the use to which the asset is put (business or personal) be understood.

Assets used in a trade or business or for the production of income are eligible for cost recovery if they are subject to wear and tear, decay or decline from natural causes, or obsolescence. Assets that do not decline in value on a predictable basis or that do not have a determinable useful life (e.g., land, stock, antiques) are not eligible for cost recovery.

Placed in Service Requirement

The key date for the commencement of depreciation is the date an asset is placed in service. This date, and not the purchase date of an asset, is the relevant date. This distinction is particularly important for an asset that is purchased near the end of the tax year, but not placed in service until after the beginning of the following tax year.

Cost Recovery Allowed or Allowable

The basis of cost recovery property must be reduced by the cost recovery *allowed* and by not less than the *allowable* amount. The allowed cost recovery is the cost recovery actually taken, whereas the allowable cost recovery is the amount that could have

been taken under the applicable cost recovery method. If the taxpayer does not claim any cost recovery on property during a particular year, the basis of the property must still be reduced by the amount of cost recovery that should have been deducted (the *allowable* cost recovery).

EXAMPLE 18

On March 15, Heron Corporation paid $10,000 for a copier to be used in its business. The copier is five-year property. Heron elected to use the straight-line method of cost recovery, but did not take any cost recovery allowance in year 3 or 4. Therefore, the allowed cost recovery (cost recovery actually deducted) and the allowable cost recovery are as follows:[55]

	Cost Recovery Allowed	Cost Recovery Allowable
Year 1	$1,000	$ 1,000
Year 2	2,000	2,000
Year 3	–0–	2,000
Year 4	–0–	2,000
Year 5	2,000	2,000
Year 6	1,000	1,000
Totals	$6,000	$10,000

The adjusted basis of the copier at the end of year 6 is $0 ($10,000 cost – $10,000 *allowable* cost recovery). If Heron sells the copier for $800 in year 7, it will recognize an $800 gain ($800 amount realized – $0 adjusted basis). ■

Cost Recovery Basis for Personal-Use Assets Converted to Business or Income-Producing Use

If personal-use assets are converted to business or income-producing use, the basis for cost recovery and for loss is the lower of the adjusted basis or the fair market value at the time the property was converted. As a result of this basis rule, losses that occurred while the property was personal-use property will not be recognized for tax purposes through the cost recovery of the property.

EXAMPLE 19

Hans acquires a personal residence for $120,000. Four years later, when the fair market value is only $100,000, he establishes a consulting company and uses the residence solely for office space. The basis for cost recovery is $100,000, since the fair market value is less than the adjusted basis. The $20,000 decline in value is deemed to be personal (since it occurred while Hans held the property for personal use). Therefore, depreciation deductions will be based on $100,000 rather than $120,000. ■

MODIFIED ACCELERATED COST RECOVERY SYSTEM (MACRS)

MACRS provides separate cost recovery periods and methods for realty (real property) and personalty (personal property). Write-offs are not available for land because it does not have a determinable useful life. Cost recovery allowances for real property, other than land, are based on recovery lives specified in the law. The IRS provides tables that specify cost recovery allowances for personalty and for realty.

COST RECOVERY FOR PERSONAL PROPERTY

MACRS provides that the cost recovery basis of eligible personalty (and certain realty) is recovered over 3, 5, 7, 10, 15, or 20 years.[56] Examples of property in the different cost recovery categories are shown in Exhibit 5.2.[57]

[55]The cost recovery allowances are based on the half-year convention, which allows a half-year's cost recovery in the first and last years of the recovery period.

[56]Property is classified by recovery period under MACRS based on asset depreciation range (ADR) midpoint lives provided by the IRS. Rev.Proc. 87–56, 1987–2 C.B. 674 is the source for the ADR midpoint lives.

[57]§ 168(e).

EXHIBIT 5.2 Cost Recovery Periods: MACRS Personalty

Class	Examples
3-year	Tractor units for use over-the-road
	Any horse that is not a racehorse and is more than 12 years old at the time it is placed in service
	Special tools used in the manufacturing of motor vehicles, such as dies, fixtures, molds, and patterns
5-year	Automobiles and taxis
	Light and heavy general-purpose trucks
	Typewriters, calculators, and copiers
	Computers and peripheral equipment
7-year	Office furniture, fixtures, and equipment
	Agricultural machinery and equipment
10-year	Vessels, barges, tugs, and similar water transportation equipment
	Assets used for petroleum refining or for the manufacture of grain and grain mill products, sugar and sugar products, or vegetable oils and vegetable oil products
	Single-purpose agricultural or horticultural structures
15-year	Land improvements
	Assets used for industrial steam and electric generation and/or distribution systems
	Assets used in the manufacture of cement
20-year	Farm buildings except single-purpose agricultural and horticultural structures
	Water utilities

Accelerated depreciation is allowed for these six MACRS classes of property. The appropriate computational methods and conventions are built into the tables, so, in general, it is not necessary to perform any calculations. To determine the amount of the cost recovery allowance, simply identify the asset by class and go to the appropriate table.[58] The MACRS percentages for personalty are shown in Table 5.1 (MACRS tables are located at the end of the chapter prior to the problem materials).

Taxpayers may *elect* the straight-line method to compute cost recovery allowances for each of these classes of property. Certain property is not eligible for accelerated cost recovery and must be depreciated under an alternative depreciation system (ADS). Both the straight-line election and ADS are discussed later in the chapter.

MACRS views property as placed in service in the middle of the first year and allows a half-year of cost recovery in the year of acquisition and in the final year of cost recovery (the **half-year convention**).[59] Thus, for example, the statutory recovery period for three-year property begins in the middle of the year the asset is placed in service and ends three years later. In practical terms, this means the actual write-off periods cover 4, 6, 8, 11, 16, and 21 tax years. MACRS also allows for a half-year of cost recovery in the year of disposition or retirement.

Robin Corporation acquires a five-year class asset on April 10, 2010, for $30,000. Robin's cost recovery deduction for 2010 is $6,000, computed as follows:

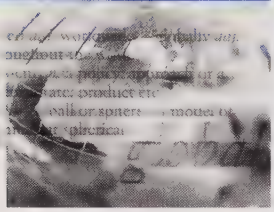
MACRS calculation based on Table 5.1 ($30,000 × .20)	$6,000

■

[58] § 168(b).

[59] § 168(d)(4)(A).

GLOBAL Tax Issues



Expensing Asset Costs for Home Office

Working at home can now pay added benefits in the United Kingdom. Beginning April 1, 2008, Her Majesty's Revenue and Customs allows 100 percent of the cost of new equipment used in a home office to be deducted against taxable income. The limit is the first £50,000 spent on eligible assets.

Source: Adapted from "Benefits of Home Working Can Outweigh Risks and Also Be a Tax Boost," *Lincolnshire Echo* (Lincoln, U.K.), August 27, 2008, p. 4.

EXAMPLE 41

Assume the same facts as in Example 40 and that Robin disposes of the asset on March 5, 2012. Robin's cost recovery deduction for 2012 is $2,880 [$30,000 × ½ × .192 (Table 5.1)]. ■

Additional First-Year Depreciation

The Federal stimulus legislation provided for **additional first-year depreciation** on qualified property acquired after 2007 and placed in service before 2010. The provision allows for an additional 50 percent cost recovery deduction in the year the asset is placed in service. *Qualified property* includes most types of *new* property other than buildings. *New* means original or first use of the property. Property that is used but newly acquired by the taxpayer does not qualify.[60]

The additional first-year depreciation is taken in the year in which the qualifying property is placed in service and may be claimed in addition to the otherwise available depreciation deduction. After calculating the additional first-year depreciation, the standard cost recovery allowance under MACRS is calculated by multiplying the cost recovery basis (original cost recovery basis less additional first-year depreciation) by the percentage that reflects the applicable cost recovery method and the applicable cost recovery convention.

A taxpayer may elect to not claim additional first-year depreciation. Examples 42 and 43 reflect the tax treatment for 2009.

EXAMPLE 42

Morgan acquires a five-year class asset on March 20, 2009, for $50,000. Morgan's cost recovery deduction for 2009 is $30,000, computed as follows.

50% additional first-year depreciation ($50,000 × .50)	$25,000
MACRS cost recovery [($50,000 − $25,000) × .20 (Table 5.1)]	5,000
Total cost recovery	$30,000

■

EXAMPLE 43

Assume the same facts as in Example 42 and that Morgan disposes of the asset on October 17, 2011. Morgan's cost recovery deduction for 2011 is $2,400 [$25,000 × ½ year × .192 (Table 5.1)]. ■

At the time of this writing, additional first-year depreciation has not been extended beyond December 31, 2009.

Mid-Quarter Convention

If more than 40 percent of the value of property from all asset classes[61] is placed in service during the last quarter of the year, a **mid-quarter convention** applies.[62]

[60] § 168(k).

[61] See Cost Recovery for Real Estate later in this chapter for a discussion of eligible real estate.

[62] § 168(d)(3).

TAX in the NEWS

Tax Incentives at the Local Level

The city council in Yakima, Washington, considered proposals for nine projects that would permit investors to claim faster depreciation deductions for their investments. The rapid depreciation permits investors to depreciate property in one year or some other short time period, instead of using the regular 30-year depreciation schedule.

Source: Adapted from David Lester, "New City Council to Review List of Projects for Possible Tax Credits," *McClatchy–Tribune Business News* (Washington), October 6, 2008.

Under the convention, property acquisitions are grouped by the quarter they were acquired for cost recovery purposes. Acquisitions during the first quarter are allowed 10.5 months (three and one-half quarters) of cost recovery; the second quarter, 7.5 months (two and one-half quarters); the third quarter, 4.5 months (one and one-half quarters); and the fourth quarter, 1.5 months. The percentages are shown in Table 5.2.

Silver Corporation puts into service the following new five-year class property in 2010.

Acquisition Dates	Cost
February 15	$ 200,000
July 10	400,000
December 5	600,000
Total	$1,200,000

If Silver Corporation uses the statutory percentage method, the cost recovery allowances for the first two years are computed as indicated below. Because more than 40% ($600,000/$1,200,000 = 50%) of the acquisitions are in the last quarter, the mid-quarter convention applies.

2010			
	Mid-Quarter Convention Depreciation		Total Depreciation
February 15	$200,000 × .35 (Table 5.2)	=	$ 70,000
July 10	$400,000 × .15	=	60,000
December 5	$600,000 × .05	=	30,000
Total			$160,000
2011			
February 15	$200,000 × .26 (Table 5.2)	=	$ 52,000
July 10	$400,000 × .34	=	136,000
December 5	$600,000 × .38	=	228,000
Total			$416,000

When property to which the mid-quarter convention applies is disposed of, the property is treated as though it were disposed of at the midpoint of the quarter. Hence, in the quarter of disposition, cost recovery is allowed for one-half of the quarter.

Assume the same facts as in Example 44, except that Silver Corporation sells the $400,000 asset on November 30, 2011. The cost recovery allowance for 2011 is computed as follows.

February 15	$200,000 × .26 (Table 5.2)	=	$ 52,000
July 10	$400,000 × .34 × (3.5/4)	=	119,000
December 5	$600,000 × .38	=	228,000
Total			$399,000

■

COST RECOVERY FOR REAL ESTATE

Under MACRS, the cost recovery period for residential rental real estate is 27.5 years, and the straight-line method is used for computing the cost recovery allowance. **Residential rental real estate** includes property where 80 percent or more of the gross rental revenues are from nontransient dwelling units (e.g., an apartment building). Hotels, motels, and similar establishments are not residential rental property. Nonresidential real estate has a recovery period of 39 years (31.5 years for such property placed in service before May 13, 1993) and is also depreciated using the straight-line method.[63]

Some items of real property are not treated as real estate for purposes of MACRS. For example, single-purpose agricultural structures are in the 10-year MACRS class. Land improvements are in the 15-year MACRS class.

All eligible real estate placed in service after June 22, 1984 (under both ACRS and MACRS) is depreciated using the **mid-month convention**.[64] Regardless of when during the month the property is placed in service, it is deemed to have been placed in service at the middle of the month. This allows for one-half month's cost recovery for the month the property is placed in service. If the property is disposed of before the end of the recovery period, one-half month's cost recovery is permitted for the month of disposition regardless of the specific date of disposition.

Cost recovery is computed by multiplying the applicable rate (taken from a table) by the cost recovery basis. The MACRS real property rates are provided in Table 5.3.

Badger Rentals, Inc., acquired a building on April 1, 1995, for $800,000. If the building is classified as residential rental real estate, the cost recovery deduction for 2010 is $29,088 (.03636 × $800,000). If the building is sold on October 7, 2010, the cost recovery deduction for 2010 is $23,028 [.03636 × (9.5/12) × $800,000]. If the building is acquired on March 2, 1993, for $1 million and is classified as nonresidential real estate, the cost recovery deduction for 2010 is $31,750 (.03175 × $1,000,000). If the building is sold on January 5, 2010, the cost recovery deduction for 2010 is $1,323 [.03175 × (.5/12) × $1,000,000]. (See the first two sections of Table 5.3 for the percentages.) ■

Oakenwood Properties, Inc., acquired a building on November 19, 2010, for $1.2 million. If the building is classified as nonresidential real estate, the cost recovery deduction for 2010 is $3,852 (.00321 × $1,200,000). The cost recovery deduction for 2011 is $30,768 (.02564 × $1,200,000). If the building is sold on May 21, 2011, the cost recovery deduction for 2011 is $11,538 [.02564 × (4.5/12) × $1,200,000]. (See the last section of Table 5.3 for the percentages.) ■

An overview of MACRS rules is provided in Concept Summary 5.1.

[63] §§ 168(b), (c), and (e).

[64] § 168(d)(1).



CONCEPT SUMMARY 5.1

MACRS Computational Rules: Statutory Percentage and Straight-Line Methods

	Personal Property	Real Property
Convention	Half-year or mid-quarter	Mid-month
Cost recovery deduction in the year of disposition	Half-year for year of disposition or half-quarter for quarter of disposition	Half-month for month of disposition

STRAIGHT-LINE ELECTION

Although MACRS requires straight-line depreciation for all eligible real estate as previously discussed, the taxpayer may *elect* to use the straight-line method for personal property.[65] The property is depreciated using the class life (recovery period) of the asset with a half-year convention or a mid-quarter convention, whichever is applicable. The election is available on a class-by-class and year-by-year basis. The percentages for the straight-line election with a half-year convention appear in Table 5.4.

EXAMPLE 48

Terry puts into service a new 10-year class asset on August 4, 2010, for $100,000. He elects the straight-line method of cost recovery. Terry's cost recovery deduction for 2010 is $5,000 ($100,000 × .05). His cost recovery deduction for 2011 is $10,000 ($100,000 × .10). (See Table 5.4 for the percentages.) ■

EXAMPLE 49

Assume the same facts as in Example 48, except that Terry sells the asset on November 21, 2011. His cost recovery deduction for 2011 is $5,000 [$100,000 × .10 × (½) (Table 5.4)]. ■

FARM PROPERTY

When tangible personal property is used in a farming business, generally the cost of the asset is recovered under MACRS using the 150 percent declining-balance method.[66] However, the MACRS straight-line method is required for any tree or vine bearing fruits or nuts.[67] The cost of real property used in the farming business is recovered over the normal periods (27.5 years and 39 years) using the straight-line method. A farming business is defined as the trade or business of farming, which includes operating a nursery or sod farm and the raising or harvesting of trees bearing fruit, nuts, or other crops, or ornamental trees.[68] The applicable cost recovery method is also affected if the taxpayer elects to not have the uniform capitalization rules apply to the farming business.[69] Under the uniform capitalization rules, the costs of property produced or acquired for resale must be capitalized. When this election is made, the cost recovery method required is the alternative depreciation system (ADS) straight-line method (discussed further later in the chapter). This method must be applied to all assets placed in service in any taxable year during which the election is in effect. Even though this election is made and the straight-line method must be used, it does not prevent the taxpayer from electing to expense personalty under § 179.[70] Exhibit 5.3 shows examples of cost recovery periods for farming assets.

[65] § 168(b)(5).
[66] § 168(b)(2)(B).
[67] §§ 168(b)(3)(E) and 168(e)(3)(D)(ii).
[68] § 263A(e)(4).
[69] § 263A(d)(3)(A).
[70] Reg. § 1.263A–4(d)(4)(ii).

EXHIBIT 5.3 Cost Recovery Periods for Farming Assets

Assets	Recovery Period in Years MACRS	ADS
Agricultural structures (single purpose)	10	15
Cattle (dairy or breeding)	5	7
Farm buildings	20	25
Farm machinery and equipment	7	10
Fences (agricultural)	7	10
Horticultural structures (single purpose)	10	15
Trees or vines bearing fruit or nuts	10	20
Truck (heavy duty, unloaded weight 13,000 pounds or more)	5	6
Truck (actual weight less than 13,000 pounds)	5	5

EXAMPLE 50

Redberry Farms, Inc., purchased new farm equipment on July 10, 2010, for $80,000. If Redberry does not elect to expense any of the cost under § 179, its cost recovery deduction for 2010 is $8,568 [(.1071 × $80,000) (Table 5.5)]. ■

EXAMPLE 51

Assume the same facts as in Example 50, except that Redberry Farms, Inc., has made an election to not have the uniform capitalization rules apply. Redberry's 2010 cost recovery deduction is $4,000 [(.05 × $80,000) (Table 5.6)]. ■

LEASEHOLD IMPROVEMENT PROPERTY

When the lessor is the owner of leasehold improvement property, the cost recovery period is the statutorily prescribed life. The recovery period for residential rental real estate is 27.5 years, and the recovery period for nonresidential real estate is 39 years. For these real property leasehold improvements, the straight-line method is used. If the improvement is tangible personal property, the shorter MACRS lives and accelerated methods are used.

When lessor-owned leasehold improvements are disposed of or abandoned by the lessor because of the termination of the lease, the property will be treated as disposed of by the lessor, and hence, a loss can be taken for the unrecovered basis.[71]

EXAMPLE 52

On April 7, 2010, Mary signed a 10-year lease with Teal Company on a building to be used for her business. The lease period begins on May 1, 2010, and ends on April 30, 2020. Prior to the signing of the lease, Teal paid $300,000 to have a unique storefront added to the building. Teal's cost recovery deduction for 2010 for the addition is $4,815 [(.01605 × $300,000) (Table 5.3)]. ■

EXAMPLE 53

Assume the same facts as in Example 52. Teal's cost recovery deduction for 2020 is $2,244 {[.02564 × (3.5/12) × $300,000] (Table 5.3)}. At the end of the lease, Teal Company has to remove the unique storefront, so it can lease the building to other tenants.

[71] § 163(i)(8)(B).

Teal's loss as a result of the termination of the lease and the removal of the unique storefront is $223,713 computed as follows:

Cost	$300,000
Less: Cost recovery	
2010 (Example 52)	(4,815)
2011–2019 (.02564 × $300,000 × 9 years)	(69,228)
2020 (.02564 × $300,000 × 3.5/12 months)	(2,244)
Loss (unrecovered cost)	$223,713

■

The costs of leasehold improvements made to leased property and owned by the lessee are recovered in accordance with the general cost recovery rules. This means that the cost recovery period is determined without regard to the lease term. Any unrecovered basis in the leasehold improvement property not retained by the lessee is deducted in the year the lease is terminated.

ELECTION TO EXPENSE ASSETS UNDER § 179

Section 179 (Election to Expense Certain Depreciable Business Assets) permits a taxpayer to elect to deduct up to $250,000 in 2010[72] of the acquisition cost of *tangible personal property* used in a trade or business. Amounts that are expensed under § 179 may not be capitalized and depreciated. The **§ 179 expensing election** is an annual election and applies to the acquisition cost of property placed in service that year. The immediate expense election is not available for real property or for property used for the production of income.[73]

In addition, any elected § 179 expense is taken *before* all other depreciation is computed. The base for calculating the standard MACRS deduction is net of the § 179 expense.

EXAMPLE 54

Kodiak Corporation acquires machinery (five-year class asset) on February 1, 2010, at a cost of $275,000 and elects to expense $250,000 under § 179. Kodiak takes the statutory percentage cost recovery (see Table 5.1 for percentage) for 2010. As a result, the total deduction for the year is calculated as follows.

§ 179 expense	$250,000
Standard MACRS calculation [($275,000 − $250,000) × .20]	5,000
	$255,000

■

Annual Limitations

Two additional limitations apply to the amount deductible under § 179. First, the ceiling amount on the deduction is reduced dollar-for-dollar when property (other than ineligible real estate) placed in service during the taxable year exceeds $800,000 in 2010 ($800,000 in 2009).[74] Second, the amount expensed under § 179 cannot exceed the aggregate amount of taxable income derived from the conduct of any trade or business by the taxpayer. Taxable income of a trade or business is computed without regard to the amount expensed under § 179. Any § 179 deduction in excess of taxable income is carried forward to future taxable years and added to other amounts eligible for expensing. The § 179 amount eligible for expensing in a carryforward year is limited to the *lesser* of (1) the appropriate statutory dollar amount ($250,000 in 2010) reduced by the cost of § 179 property placed in service in excess of $800,000 in the carryforward year or (2) the business income limitation in the carryforward year.

[72] At the time of this writing, pending legislation in Congress increases the statutory amount from $134,000 to $250,000. The expense amount also was $250,000 for assets placed in service in 2008 and 2009.

[73] §§ 179(b) and (d).

[74] At the time of this writing, pending legislation in Congress increases the statutory amount from $530,000 to $800,000.

Bridge DISCIPLINE

Bridge to Economics and the Business Cycle

Congress has passed several stimulus packages intended to stabilize and accelerate the economy. One provision increased the amount of certain fixed asset acquisition costs that could be expensed rather than depreciated. Given the still-faltering economy, however, many companies are not able to take advantage of the increased deductions because they cannot afford to purchase new assets. Businesses do not purchase assets simply to save on taxes.

Source: Adapted from Joyce Rosenberg, "Deduction Dilemma Hits Companies," *Telegraph Herald* (Dubuque, Iowa), November 9, 2008, p. B2.

EXAMPLE 55

Jill owns a computer service and operates it as a sole proprietorship. In 2010, she will net $11,000 before considering any § 179 deduction. If Jill spends $825,000 on new equipment, her § 179 expense deduction is computed as follows.

§ 179 deduction before adjustment	$250,000
Less: Dollar limitation reduction ($825,000 − $800,000)	(25,000)
Remaining § 179 deduction	$225,000
Business income limitation	$ 11,000
§ 179 deduction allowed	$ 11,000
§ 179 deduction carryforward ($225,000 − $11,000)	$214,000

■

Effect on Basis

The basis of the property for cost recovery purposes is reduced by the § 179 amount after it is adjusted for property placed in service in excess of $800,000. This adjusted amount does not reflect any business income limitation.

EXAMPLE 56

Assume the same facts as in Example 55 and that the new equipment is five-year class property. After considering the § 179 deduction, Jill's cost recovery deduction for 2010 is calculated as follows. (See Table 5.1 for the percentage.)

Standard MACRS calculation [($825,000 − $225,000) × .20]	$120,000

■

BUSINESS AND PERSONAL USE OF AUTOMOBILES AND OTHER LISTED PROPERTY

Limits exist on MACRS deductions for automobiles and other **listed property** used for both personal and business purposes.[75] These limits would apply, for example, to an automobile used by a sole proprietor partly for business purposes and partly for personal use.

If the listed property is *predominantly* used for business, the taxpayer is allowed to use the *statutory percentage method* to recover the cost. In cases where the property is *not predominantly* used for business, the cost is recovered using the *straight-line method.* The statutory percentage method results in a faster recovery of cost than the straight-line method. Listed property includes the following:

- Any passenger automobile.
- Any other property used as a means of transportation.
- Any property of a type generally used for purposes of entertainment, recreation, or amusement.

[75] § 280F.

- Any computer or peripheral equipment, with the exception of equipment used exclusively at a regular business establishment, including a qualifying home office.
- Any cellular telephone or other similar telecommunications equipment.
- Any other property specified in the Regulations.

Automobiles and Other Listed Property Used Predominantly in Business

For listed property to be considered as predominantly used in business, its *business usage* must exceed 50 percent.[76] The use of listed property for production of income does not qualify as business use for purposes of the more-than-50 percent test. However, both production-of-income and business-use percentages are used to compute the cost recovery deduction.

EXAMPLE 51

On September 1, 2010, Emma places in service listed five-year recovery property. The property cost $10,000. If Emma uses the property 40% for business and 25% for the production of income, the property is not considered as predominantly used for business. The cost is recovered using straight-line cost recovery. Emma's cost recovery allowance for the year is $650 ($10,000 × .10 × .65). If, however, Emma uses the property 60% for business and 25% for the production of income, the property is considered as used predominantly for business. Therefore, she may use the statutory percentage method. Emma's cost recovery allowance for the year is $1,700 ($10,000 × .20 × .85). ■

The method for determining the percentage of business usage for listed property is specified in the Regulations. The Regulations provide that for automobiles a mileage-based percentage is to be used. Other listed property is to use the most appropriate unit of time (e.g., hours) the property is actually used (rather than available for use).[77]

Limits on Cost Recovery for Automobiles

The law places special limitations on the cost recovery deduction for *passenger automobiles.*[78] These statutory dollar limits were imposed on passenger automobiles because of the belief that the tax system was being used to underwrite automobiles whose cost and luxury far exceeded what was needed for their business use.

The following limits apply to the cost recovery deductions for passenger automobiles for 2010.[79]

Year of Use	Recovery Limitation
1	$3,060
2	4,900
3	2,950
Succeeding years until all cost is recovered	1,775

The "luxury auto" limitation for subsequent years' cost recovery is based on the limits for the year the automobile was placed in service. Hence, the limit for the third year's cost recovery for an automobile placed in service in 2010 is $2,950 and not a limit published in a later year.[80]

There are also separate cost recovery limitations for trucks and vans and for electric automobiles. Because these limitations are applied in the same manner as those imposed on passenger automobiles, these additional limitations are not discussed further in this chapter.

[76] § 280F(b)(3).
[77] Reg. § 1.280F–6T(e).
[78] § 280F(d)(5).
[79] § 280F(a)(1).
[80] Cost recovery limitations for prior years are found in IRS Publication 463.

The limits are imposed before any percentage reduction for personal use. In addition, the limitation in the first year includes any amount the taxpayer elects to expense under § 179.[81] If the passenger automobile is used partly for personal use, the personal-use percentage is ignored for the purpose of determining the unrecovered cost available for deduction in later years.

EXAMPLE 58

On July 1, 2010, Dan places in service a new automobile that cost $40,000. He does not elect § 179 expensing. The car is always used 80% for business and 20% for personal purposes. Dan chooses the MACRS 200% declining-balance method of cost recovery (see the 5-year column in Table 5.1). The depreciation computation for 2010–2015 is summarized below:

Year	MACRS Amount	Recovery Limitation	Depreciation Allowed
2010	$6,400 ($40,000 × 20% × 80%)	$2,448 ($3,060 × 80%)	$2,448
2011	$10,240 ($40,000 × 32% × 80%)	$3,920 ($4,900 × 80%)	$3,920
2012	$6,144 ($40,000 × 19.2% × 80%)	$2,360 ($2,950 × 80%)	$2,360
2013	$3,686 ($40,000 × 11.52% × 80%)	$1,420 ($1,775 × 80%)	$1,420
2014	$3,686 ($40,000 × 11.52% × 80%)	$1,420 ($1,775 × 80%)	$1,420
2015	$1,843 ($40,000 × 5.76% × 80%)	$1,420 ($1,775 × 80%)	$1,420

The cost recovery allowed is the lesser of the MACRS amount or the recovery limitation. If Dan continues to use the car after 2015, his cost recovery is limited to the lesser of the recoverable basis or the recovery limitation (i.e., $1,775 × business-use percentage). For this purpose, the recoverable basis is computed as if the full recovery limitation was allowed even if it was not. Thus, the recoverable basis as of January 1, 2016, is $23,765 ($40,000 − $3,060 − $4,900 − $2,950 − $1,775 − $1,775 − $1,775). ■

The cost recovery limitations are maximum amounts. If the regular calculation produces a lesser amount of cost recovery, the lesser amount is used.

EXAMPLE 59

On April 2, 2010, Gail places in service a pre-owned automobile that cost $10,000. The car is always used 70% for business and 30% for personal use. Therefore, the cost recovery allowance for 2010 is $1,400 ($10,000 × .20 × .70), which is less than $2,142 ($3,060 × .70). ■

The cost recovery limitations apply *only* to passenger automobiles and not to other listed property.

Special Limitation

A $25,000 maximum applies to the § 179 deduction for certain vehicles not subject to the statutory dollar limits on cost recovery deductions that are imposed on passenger automobiles. The limit applies to sport utility vehicles (SUVs) with an unloaded gross vehicle weight (GVW) rating of more than 6,000 pounds and not more than 14,000 pounds.[82]

EXAMPLE 60

During 2010, Jay acquires and places in service an SUV that cost $70,000 and has a GVW of 8,000 pounds. Jay uses the vehicle 100% of the time for business purposes. The total deduction for 2010 with respect to the SUV is $34,000, computed as follows:

§ 179 expense	$25,000
Standard MACRS calculation [($70,000 − $25,000) × .20 (Table 5.1)]	9,000
Total	$34,000

■

[81] § 280F(d)(1).

[82] § 179(b)(6).

Automobiles and Other Listed Property Not Used Predominantly in Business

The cost of listed property that does not pass the more-than-50 percent business usage test in the year the property is placed in service must be recovered using the straight-line method.[83] The straight-line method to be used is that required under the alternative depreciation system (introduced later in the chapter). This system requires a straight-line recovery period of five years for automobiles. However, even though the straight-line method is used, the cost recovery allowance for passenger automobiles cannot exceed the dollar limitations noted above.

If the listed property fails the more-than-50 percent business usage test, the straight-line method must be used for the remainder of the property's life. This applies even if at some later date the business usage of the property increases to more than 50 percent. Even though the straight-line method must continue to be used, however, the amount of cost recovery will reflect the increase in business usage.

Change from Predominantly Business Use

If the business-use percentage of listed property falls to 50 percent or lower after the year the property is placed in service, the property is subject to *cost recovery recapture.* The amount required to be recaptured and included in the taxpayer's return as ordinary income is the excess cost recovery. *Excess cost recovery* is the excess of the cost recovery deduction taken in prior years using the statutory percentage method over the amount that would have been allowed if the straight-line method had been used since the property was placed in service.[84]

After the business usage of the listed property drops below the more-than-50 percent level, the straight-line method must be used for the remaining life of the property.

Leased Automobiles

A taxpayer who leases a passenger automobile for business purposes must report an *inclusion amount* in gross income. The inclusion amount is computed from an IRS table for each taxable year for which the taxpayer leases the automobile. The purpose of this provision is to prevent taxpayers from circumventing the cost recovery dollar limitations by leasing, instead of purchasing, an automobile.

The dollar amount of the inclusion is based on the fair market value of the automobile and is prorated for the number of days the auto is used during the taxable year. The prorated dollar amount is then multiplied by the business and income-producing usage percentage to determine the amount to be included in gross income.[85] The taxpayer deducts the lease payments, multiplied by the business and income-producing usage percentage. The net effect is that the annual deduction for the lease payment is reduced by the inclusion amount.

EXAMPLE 53

On April 1, 2010, Jim leases and places in service a passenger automobile worth $40,000. The lease is to be for a period of five years. During the taxable years 2010 and 2011, Jim uses the automobile 70% for business and 30% for personal use. Assuming the dollar amounts from the IRS table for 2010 and 2011 are $166 and $363, Jim must include $88 in gross income for 2010 and $254 for 2011, computed as follows.

2010	$166 × (275/365) × .70 = $88
2011	$363 × (365/365) × .70 = $254

In addition, Jim can deduct 70% of the lease payments each year because this is the business-use percentage. ■

[83] § 280F(b)(1).
[84] § 280F(b)(2).
[85] Reg. § 1.280F–7(a).



Bridge to Finance and Economics

A new car, on average, loses a much larger portion of its value during the first five years through economic depreciation than it loses during later years. Depreciation accounts for about 35 percent of the ownership costs of a car during this five-year period.

Leasing a car will not eliminate the problem because the monthly lease payments are determined, in part, by the value of the car at the end of the lease. Because a new car loses its value faster in the earlier years, the shorter the lease, the higher the economic cost of depreciation.

Substantiation Requirements

Listed property is subject to the substantiation requirements of § 274. This means that the taxpayer must prove the business usage as to the amount of expense or use, the time and place of use, the business purpose for the use, and the business relationship to the taxpayer of persons using the property. Substantiation requires adequate records or sufficient evidence corroborating the taxpayer's statement. However, these substantiation requirements do not apply to vehicles that, by reason of their nature, are not likely to be used more than a *de minimis* amount for personal purposes.[86]

ALTERNATIVE DEPRECIATION SYSTEM (ADS)

The **alternative depreciation system (ADS)** must be used in lieu of MACRS:[87]

- To calculate the portion of depreciation treated as an alternative minimum tax (AMT) adjustment (see Chapter 14).[88]
- To compute depreciation allowances for property:
  - Used predominantly outside the United States.
  - Leased or otherwise used by a tax-exempt entity.
  - Financed with the proceeds of tax-exempt bonds.
  - Imported from foreign countries that maintain discriminatory trade practices or otherwise engage in discriminatory acts.
- To compute depreciation allowances as part of earnings and profits (see Chapter 10).

Tables 5.5, 5.6, and 5.7 provide cost recovery rates under the ADS method. Generally, personal property is depreciated under the ADS using the appropriate asset class life (e.g., 5- or 7-year) and the 150 percent declining-balance method. ADS uses straight-line depreciation for all realty, over a 40-year class life.

5.8 Amortization

LO.7

Identify intangible assets that are eligible for amortization and calculate the amount of the deduction.

Taxpayers can claim an **amortization** deduction on certain intangible assets. The amount of the deduction is determined by amortizing the adjusted basis of such intangibles ratably over a 15-year period beginning in the month in which the intangible is acquired.[89]

An amortizable § 197 intangible is any § 197 intangible acquired after August 10, 1993, and held in connection with the conduct of a trade or business or for the production of income. Section 197 intangibles include goodwill and going-concern

[86] §§ 274(d) and (i).

[87] § 168(g).

[88] This AMT adjustment applies for real and personal property placed in service before 1999. However, it continues to apply for personal property placed in service after 1998, if the taxpayer uses the 200% declining-balance method for regular income tax purposes. See Chapter 14.

[89] § 197(a).

value, franchises, trademarks, and trade names. Covenants not to compete, copyrights, and patents are also included if they are acquired in connection with the acquisition of a business. Generally, self-created intangibles are not § 197 intangibles. The 15-year amortization period applies regardless of the actual useful life of an amortizable § 197 intangible. No other depreciation or amortization deduction is permitted with respect to any amortizable § 197 intangible except those permitted under the 15-year amortization rules.

EXAMPLE 32

On June 1, Sally purchased and began operating the Falcon Café. Of the purchase price, $90,000 is correctly allocated to goodwill. The year's amortization deduction is $3,500 [($90,000/15) × (7/12)]. ■

Tax Planning Strategies STRUCTURING THE SALE OF A BUSINESS

FRAMEWORK FOCUS: TAX RATE

Strategy: Control the Character of Income and Deductions.

On the sale of a sole proprietorship where the sales price exceeds the fair market value of the tangible assets and stated intangible assets, a planning opportunity may exist for both the seller and the buyer.

The seller's preference is for the excess amount to be allocated to *goodwill* because goodwill is a capital asset whose sale may result in favorably taxed long-term capital gain. Amounts received for a *covenant not to compete,* however, produce ordinary income, which is not subject to favorable long-term capital gain rates.

Because a covenant and goodwill both are amortized over a statutory 15-year period, the tax results of a covenant not to compete versus goodwill are the same for the *buyer.* However, the buyer should recognize that an allocation to goodwill rather than a covenant may provide a tax benefit to the seller. Therefore, the buyer, in negotiating the purchase price, should factor in the tax benefit to the seller of having the excess amount labeled goodwill rather than a covenant not to compete. Of course, if the noncompetition aspects of a covenant are important to the buyer, a portion of the excess amount can be assigned to a covenant.

5.9 DEPLETION

LO.8

Determine the amount of depletion expense and recognize the alternative tax treatments for intangible drilling and development costs.

Natural resources (e.g., oil, gas, coal, gravel, timber) are subject to **depletion**, which is simply a form of depreciation applicable to natural resources. Land generally cannot be depleted.

The owner of an interest in the natural resource is entitled to deduct depletion. An owner is one who has an economic interest in the property.[90] An economic interest requires the acquisition of an interest in the resource in place and the receipt of income from the extraction or severance of that resource. Although all natural resources are subject to depletion, oil and gas wells are used as an example in the following paragraphs to illustrate the related costs and issues.

In developing an oil or gas well, the producer typically incurs:

- Natural resource costs.
- Intangible drilling and development costs.
- Tangible asset costs.
- Operating costs.

Natural resources are physically limited, and the costs to acquire them (e.g., oil under the ground) are, therefore, recovered through depletion. Costs incurred in

[90]Reg. § 1.611–1(b).

making the property ready for drilling such as the cost of labor in clearing the property, erecting derricks, and drilling the hole are **intangible drilling and development costs (IDC)**. These costs generally have no salvage value and are a lost cost if the well is not productive (dry). Costs for tangible assets such as tools, pipes, and engines are capital in nature. These costs must be capitalized and recovered through depreciation (cost recovery). Costs incurred after the well is producing are operating costs. These costs would include expenditures for such items as labor, fuel, and supplies. Operating costs are deductible when incurred (on the accrual basis) or when paid (on the cash basis).

The expenditures for depreciable assets and operating costs pose no unusual problems for producers of natural resources. The tax treatment of depletable costs and intangible drilling and development costs is quite a different matter.

INTANGIBLE DRILLING AND DEVELOPMENT COSTS (IDC)

Intangible drilling and development costs can be handled in one of two ways at the option of the taxpayer. They can be either charged off as an expense in the year in which they are incurred or capitalized and written off through depletion. The taxpayer makes the election in the first year such expenditures are incurred either by taking a deduction on the return or by adding them to the depletable basis. No formal statement of intent is required. Once made, the election is binding on both the taxpayer and the IRS for all such expenditures in the future. If the taxpayer fails to make the election to expense IDC on the original timely filed return the first year such expenditures are incurred, an automatic election to capitalize them has been made and is irrevocable.

As a general rule, it is more advantageous to expense IDC. The obvious benefit of an immediate write-off (as opposed to a deferred write-off through depletion) is not the only advantage. Since a taxpayer can use percentage depletion, which is calculated without reference to basis, the IDC may be completely lost as a deduction if they are capitalized.

DEPLETION METHODS

There are two methods of calculating depletion: cost and percentage. **Cost depletion** can be used on any wasting asset (and is the only method allowed for timber). **Percentage depletion** is subject to a number of limitations, particularly for oil and gas deposits. Depletion should be calculated both ways, and the method that results in the larger deduction should be used. The choice between cost depletion and percentage depletion is an annual decision. Thus, the taxpayer can use cost depletion in one year and percentage depletion in the following year.

Cost Depletion

Cost depletion is determined by using the adjusted basis of the asset.[91] The basis is divided by the estimated recoverable units of the asset (e.g., barrels, tons) to arrive at the depletion per unit. The depletion per unit then is multiplied by the number of units sold (not the units produced) during the year to arrive at the cost depletion allowed. Cost depletion, therefore, resembles the units-of-production method of calculating depreciation.

EXAMPLE 61

On January 1, 2010, Pablo purchases the rights to a mineral interest for $1 million. At that time, the remaining recoverable units in the mineral interest are estimated to be 200,000. The depletion per unit is $5 [$1,000,000 (adjusted basis)/200,000 (estimated recoverable units)]. If during the year 60,000 units are mined and 25,000 are sold, the cost depletion is $125,000 [$5 (depletion per unit) × 25,000 (units sold)]. ■

If the taxpayer later discovers that the original estimate was incorrect, the depletion per unit for future calculations must be redetermined based on the revised estimate.[92]

[91] § 612.

[92] § 611(a).

EXHIBIT 5.4 Sample of Percentage Depletion Rates

22% Depletion	
Cobalt	Sulfur
Lead	Tin
15% Depletion	
Copper	Oil and gas
Gold	Silver
10% Depletion	
Coal	Perlite
5% Depletion	
Gravel	Sand

EXAMPLE 64

Assume the same facts as in Example 63. In 2011, Pablo realizes that an incorrect estimate was made. The remaining recoverable units now are determined to be 400,000. Based on this new information, the revised depletion per unit is $2.1875 [$875,000 (adjusted basis)/400,000 (estimated recoverable units)]. The adjusted basis is the original cost ($1,000,000) reduced by the depletion claimed in 2010 ($125,000). If 30,000 units are sold in 2011, the depletion for the year is $65,625 [$2.1875 (depletion per unit) × 30,000 (units sold)]. ■

Percentage Depletion

Percentage depletion (also referred to as statutory depletion) is based on a specified percentage provided in the Code. The percentage varies according to the type of mineral interest involved. A sample of these percentages is shown in Exhibit 5.4. The rate is applied to the gross income from the property, but in no event may percentage depletion exceed 50 percent of the taxable income from the property before the allowance for depletion.[93]

EXAMPLE 65

Assuming gross income of $100,000, a depletion rate of 22%, and other expenses relating to the property of $60,000, the depletion allowance is determined as follows.

Gross income	$100,000
Less: Other expenses	(60,000)
Taxable income before depletion	$ 40,000
Depletion allowance [the lesser of $22,000 (22% × $100,000) or $20,000 (50% × $40,000)]	(20,000)
Taxable income after depletion	$ 20,000

The adjusted basis of the property is reduced by $20,000, the depletion allowed. If the other expenses had been only $55,000, the full $22,000 could have been deducted, and the adjusted basis would have been reduced by $22,000. ■

Note that percentage depletion is based on a percentage of the gross income from the property and makes no reference to cost. Thus, when percentage depletion is used, it is possible to deduct more than the original cost of the property. If percentage depletion is used, however, the adjusted basis of the property (for computing cost depletion) must be reduced by the amount of percentage depletion taken until the adjusted basis reaches zero.

[93] § 613(a). Special rules apply for certain oil and gas wells under § 613A (e.g., the 50% ceiling is replaced with a 100% ceiling, and the percentage depletion may not exceed 65% of the taxpayer's taxable income from all sources before the allowance for depletion).

Tax Planning Strategies SWITCHING DEPLETION METHODS

FRAMEWORK FOCUS: DEDUCTIONS

Strategy: Maximize Deductible Amounts.

While there is a positive basis in a depletable asset, cost depletion or percentage depletion, whichever method the taxpayer elects, is used. When the basis of the asset is exhausted, percentage depletion still can be taken.

EXAMPLE 66

Assume the following facts for Warbler Company.

Remaining depletable basis	$ 11,000
Gross income (10,000 units)	100,000
Expenses (other than depletion)	$30,000
Percentage depletion rate	22%

Since cost depletion is limited to the basis of $11,000 and the percentage depletion is $22,000, Warbler would choose the latter. The asset basis then is reduced to zero.

In future years, however, Warbler can continue to use percentage depletion since percentage depletion is computed without reference to the remaining asset basis. ■

5.10 COST RECOVERY TABLES

Summary of Cost Recovery Tables

Table 5.1	MACRS statutory percentage table for personalty. Applicable depreciation methods: 200 or 150 percent declining-balance switching to straight-line. Applicable recovery periods: 3, 5, 7, 10, 15, 20 years. Applicable convention: half-year.
Table 5.2	MACRS statutory percentage table for personalty. Applicable depreciation method: 200 percent declining-balance switching to straight-line. Applicable recovery periods: 3, 5, 7 years. Applicable convention: mid-quarter.
Table 5.3	MACRS straight-line table for realty. Applicable depreciation method: straight-line. Applicable recovery periods: 27.5, 31.5, 39 years. Applicable convention: mid-month.
Table 5.4	MACRS optional straight-line table for personalty. Applicable depreciation method: straight-line. Applicable recovery periods: 3, 5, 7, 10, 15, 20 years. Applicable convention: half-year.
Table 5.5	ADS declining-balance table for personalty. Applicable depreciation method: 150 percent declining-balance switching to straight-line. Applicable recovery periods: 3, 5, 7, 9.5, 10, 12 years. Applicable convention: half-year.
Table 5.6	ADS straight-line table for personalty. Applicable depreciation method: straight-line. Applicable recovery periods: 5, 10, 12 years. Applicable convention: half-year.
Table 5.7	ADS straight-line table for realty. Applicable depreciation method: straight-line. Applicable recovery period: 40 years. Applicable convention: mid-month.

TABLE 5.1 MACRS Accelerated Depreciation for Personal Property Assuming Half-Year Convention

For Property Placed in Service after December 31, 1986

Recovery Year	3-Year (200% DB)	5-Year (200% DB)	7-Year (200% DB)	10-Year (200% DB)	15-Year (150% DB)	20-Year (150% DB)
1	33.33	20.00	14.29	10.00	5.00	3.750
2	44.45	32.00	24.49	18.00	9.50	7.219
3	14.81*	19.20	17.49	14.40	8.55	6.677
4	7.41	11.52*	12.49	11.52	7.70	6.177
5		11.52	8.93*	9.22	6.93	5.713
6		5.76	8.92	7.37	6.23	5.285
7			8.93	6.55*	5.90*	4.888
8			4.46	6.55	5.90	4.522
9				6.56	5.91	4.462*
10				6.55	5.90	4.461
11				3.28	5.91	4.462
12					5.90	4.461
13					5.91	4.462
14					5.90	4.461
15					5.91	4.462
16					2.95	4.461
17						4.462
18						4.461
19						4.462
20						4.461
21						2.231

*Switchover to straight-line depreciation.

TABLE 5.2 MACRS Accelerated Depreciation for Personal Property Assuming Mid-Quarter Convention

For Property Placed in Service after December 31, 1986 (Partial Table*)

		3-Year		
Recovery Year	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
1	58.33	41.67	25.00	8.33
2	27.78	38.89	50.00	61.11

		5-Year		
Recovery Year	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
1	35.00	25.00	15.00	5.00
2	26.00	30.00	34.00	38.00

		7-Year		
Recovery Year	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
1	25.00	17.85	10.71	3.57
2	21.43	23.47	25.51	27.55

*The figures in this table are taken from the official tables that appear in Rev.Proc. 87–57, 1987–2 C.B. 687. Because of their length, the complete tables are not presented.

TABLE 5.3 MACRS Straight-Line Depreciation for Real Property Assuming Mid-Month Convention*

For Property Placed in Service after December 31, 1986: 27.5-Year Residential Real Property

Recovery Year(s)	The Applicable Percentage Is (Use the Column for the Month in the First Year the Property Is Placed in Service): 1	2	3	4	5	6	7	8	9	10	11	12
1	3.485	3.182	2.879	2.576	2.273	1.970	1.667	1.364	1.061	0.758	0.455	0.152
2–18	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636
19–27	3.637	3.637	3.637	3.637	3.637	3.637	3.637	3.637	3.637	3.637	3.637	3.637
28	1.970	2.273	2.576	2.879	3.182	3.485	3.636	3.636	3.636	3.636	3.636	3.636
29	0.000	0.000	0.000	0.000	0.000	0.000	0.152	0.455	0.758	1.061	1.364	1.667

For Property Placed in Service after December 31, 1986, and before May 13, 1993: 31.5-Year Nonresidential Real Property

Recovery Year(s)	The Applicable Percentage Is (Use the Column for the Month in the First Year the Property Is Placed in Service): 1	2	3	4	5	6	7	8	9	10	11	12
1	3.042	2.778	2.513	2.249	1.984	1.720	1.455	1.190	0.926	0.661	0.397	0.132
2–19	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175
20–31	3.174	3.174	3.174	3.174	3.174	3.174	3.174	3.174	3.174	3.174	3.174	3.174
32	1.720	1.984	2.249	2.513	2.778	3.042	3.175	3.175	3.175	3.175	3.175	3.175
33	0.000	0.000	0.000	0.000	0.000	0.000	0.132	0.397	0.661	0.926	1.190	1.455

For Property Placed in Service after May 12, 1993: 39-Year Nonresidential Real Property

Recovery Year(s)	The Applicable Percentage Is (Use the Column for the Month in the First Year the Property Is Placed in Service): 1	2	3	4	5	6	7	8	9	10	11	12
1	2.461	2.247	2.033	1.819	1.605	1.391	1.177	0.963	0.749	0.535	0.321	0.107
2–39	2.564	2.564	2.564	2.564	2.564	2.564	2.564	2.564	2.564	2.564	2.564	2.564
40	0.107	0.321	0.535	0.749	0.963	1.177	1.391	1.605	1.819	2.033	2.247	2.461

*The official tables contain a separate row for each year. For ease of presentation, certain years are grouped in these tables. In some instances, this will produce a difference of .001 for the last digit when compared with the official tables.

TABLE 5.4 MACRS Straight-Line Depreciation for Personal Property Assuming Half-Year Convention*

For Property Placed in Service after December 31, 1986

MACRS Class	% First Recovery Year	Other Recovery Years		Last Recovery Year	
		Years	%	Year	%
3-year	16.67	2–3	33.33	4	16.67
5-year	10.00	2–5	20.00	6	10.00
7-year	7.14	2–7	14.29	8	7.14
10-year	5.00	2–10	10.00	11	5.00
15-year	3.33	2–15	6.67	16	3.33
20-year	2.50	2–20	5.00	21	2.50

*The official table contains a separate row for each year. For ease of presentation, certain years are grouped in this table. In some instances, this will produce a difference of .01 for the last digit when compared with the official table.

TABLE 5.5 ADS 150% Declining-Balance Assuming Half-Year Convention

For Property Placed in Service after December 31, 1986 (Partial Table*)

Recovery Year	3-Year 150%	5-Year 150%	7-Year 150%	9.5-Year 150%	10-Year 150%	12-Year 150%
1	25.00	15.00	10.71	7.89	7.50	6.25
2	37.50	25.50	19.13	14.54	13.88	11.72
3	25.00**	17.85	15.03	12.25	11.79	10.25
4	12.50	16.66**	12.25**	10.31	10.02	8.97
5		16.66	12.25	9.17**	8.74**	7.85
6		8.33	12.25	9.17	8.74	7.33**
7			12.25	9.17	8.74	7.33
8			6.13	9.17	8.74	7.33
9				9.17	8.74	7.33
10				9.16	8.74	7.33
11					4.37	7.32
12						7.33
13						3.66

*The figures in this table are taken from the official table that appears in Rev.Proc. 87–57, 1987–2 C.B. 687. Because of its length, the complete table is not presented.

**Switchover to straight-line depreciation.

TABLE 5.6 ADS Straight-Line for Personal Property Assuming Half-Year Convention

For Property Placed in Service after December 31, 1986 (Partial Table*)

Recovery Year	5-Year Class	10-Year Class	12-Year Class
1	10.00	5.00	4.17
2	20.00	10.00	8.33
3	20.00	10.00	8.33
4	20.00	10.00	8.33
5	20.00	10.00	8.33
6	10.00	10.00	8.33
7		10.00	8.34
8		10.00	8.33
9		10.00	8.34
10		10.00	8.33
11		5.00	8.34
12			8.33
13			4.17

*The figures in this table are taken from the official table that appears in Rev.Proc. 87–57, 1987–2 C.B. 687. Because of its length, the complete table is not presented. The tables for the mid-quarter convention also appear in Rev.Proc. 87–57.

TABLE 5.7 ADS Straight-Line for Real Property Assuming Mid-Month Convention

For Property Placed in Service after December 31, 1986

Recovery Year(s)	Month Placed in Service 1	2	3	4	5	6	7	8	9	10	11	12
1	2.396	2.188	1.979	1.771	1.563	1.354	1.146	0.938	0.729	0.521	0.313	0.104
2–40	2.500	2.500	2.500	2.500	2.500	2.500	2.500	2.500	2.500	2.500	2.500	2.500
41	0.104	0.312	0.521	0.729	0.937	1.146	1.354	1.562	1.771	1.979	2.187	2.396

REFOCUS ON THE BIG PICTURE

CALCULATION OF DEDUCTIBLE EXPENSES

In general, the expenses incurred in Dr. Stevens's practice are deductible as long as they are ordinary and necessary expenses. In addition, the salaries and wages paid must be reasonable. Charitable contributions generally are limited to 10 percent of taxable income before the charitable contribution deduction, and political contributions are not deductible. Dr. Stevens can elect to expense the costs of the dental equipment and office furnishings under the provisions of § 179. For 2010, the § 179 deduction is limited to $250,000 and cannot exceed the taxable income derived from the business (before the § 179 deduction). In this case, the entire $180,000 is deductible.

Gross revenue	$ 485,500
Less: Salaries and wages	(150,000)
Building rent	(24,000)
§ 179 deduction	(180,000)
Insurance	(12,000)
Utilities	(12,000)
Taxes and licenses	(6,000)
Advertising	(3,000)
Interest expense	(6,000)
Taxable income before the charitable contribution deduction	$ 92,500
Less: Charitable contributions (limited to 10% of taxable income)	(3,000)
Taxable income	$ 89,500

What If?

Instead assume that Dr. Stevens purchased $270,000 of new equipment and furnishings of the type that qualifies for the § 179 deduction? Dr. Stevens can elect to expense up to $250,000 of the cost under § 179. The remaining $20,000 of basis can be depreciated using the regular MACRS rules. For seven-year property, the first-year depreciation deduction is 14.29 percent or $2,858. In summary, total cost recovery for the property in 2010 is $252,858. As a result of the increased depreciation, the charitable contribution deduction now is limited to $1,964. The remainder ($1,036) may be carried over to the next tax year.

CONTINUED

Gross revenue	$ 485,500
Less: Salaries and wages	(150,000)
Building rent	(24,000)
§ 179 deduction	(250,000)
MACRS depreciation	(2,858)
Insurance	(12,000)
Utilities	(12,000)
Taxes and licenses	(6,000)
Advertising	(3,000)
Interest expense	(6,000)
Taxable income before the charitable contribution deduction	$ 19,642
Less: Charitable contributions (limited to 10% of taxable income)	(1,964)
Taxable income	$ 17,678

SUGGESTED READINGS

Sidney J. Baxendale and William D. Stout, "Recent Tax Law Changes Factor into the Auto Lease vs. Purchase Decision," *Practical Tax Strategies*, September 2008.

Robert Bloom and William J. Cenker, "Fixed-Asset Deduction Disparities for Tax and Nontax Accounting," *Practical Tax Strategies*, October 2009.

John O. Everett, Cherie J. Hennig, and William A. Raabe, "Evaluating the Accelerated Research and AMT Credits Election under Section 168(k)(4)," *Journal of Taxation*, June 2009.

Nicholas J. Fiore, "Prepaid Services Must Be Fully Completed to Use 3½-Month Rule," *The Tax Adviser*, August 2007.

John C. Zimmerman, "When Does Prepaying Expenses Accelerate Tax Deductions?" *Practical Tax Strategies*, November 2007.

KEY TERMS

Accelerated cost recovery system (ACRS), 5–22

Additional first-year depreciation, 5–26

Alternative depreciation system (ADS), 5–36

Amortization, 5–36

Capital gain property, 5–15

Charitable contribution, 5–14

Cost depletion, 5–38

Depletion, 5–37

Depreciation rules, 5–22

Domestic production activities deduction (DPAD), 5–20

Domestic production gross receipts (DPGR), 5–21

Half-year convention, 5–25

Intangible drilling and development costs (IDC), 5–38

Listed property, 5–32

Mid-month convention, 5–28

Mid-quarter convention, 5–26

Modified accelerated cost recovery system (MACRS), 5–22

Modified adjusted gross income, 5–20

Ordinary and necessary, 5–3

Ordinary income property, 5–15

Percentage depletion, 5–38

Qualified production activities income (QPAI), 5–21

Reasonableness requirement, 5–3

Related-party transactions, 5–11

Research and experimental expenditures, 5–17

Residential rental real estate, 5–28

Section 179 expensing election, 5–31

W–2 wages, 5–21

PROBLEMS

ISSUE ID

1. **LO.3** Ted is an agent for Waxwing Corporation, an airline manufacturer, and is negotiating a sale with a representative of the U.S. government and with a representative of a developing country. Waxwing has sufficient capacity to handle only one of the orders. Both orders will have the same contract price. Ted believes that if Waxwing will authorize a $500,000 payment to the representative of the foreign country, he can guarantee the sale. He is not sure that he can obtain the same result with the U.S. government. Identify the relevant tax issues for Waxwing.

2. **LO.3** Linda operates a drug-running operation. Which of the following expenses she incurs can reduce taxable income?
   a. Bribes paid to border guards.
   b. Salaries to employees.
   c. Price paid for drugs purchased for resale.
   d. Kickbacks to police.
   e. Rent on an office.
   f. Depreciation on office furniture and equipment.
   g. Tenant's casualty insurance.

ETHICS AND EQUITY

3. **LO.3** Cardinal Corporation is a trucking firm that operates in the Mid-Atlantic states. One of Cardinal's major customers frequently ships goods between Charlotte and Baltimore. Occasionally, the customer sends last-minute shipments that are outbound for Europe on a freighter sailing from Baltimore. To satisfy the delivery schedule in these cases, Cardinal's drivers must substantially exceed the speed limit. Cardinal pays for any related speeding tickets. During the past year, two drivers had their licenses suspended for 30 days each for driving at such excessive speeds. Cardinal continues to pay each driver's salary during the suspension periods.

   Cardinal believes that it is necessary to conduct its business in this manner if it is to be profitable, maintain the support of the drivers, and maintain the goodwill of customers. Evaluate Cardinal's business practices.

4. **LO.3** Quail Corporation anticipates that being positively perceived by the individual who is elected mayor will be beneficial for business. Therefore, Quail contributes to the campaigns of both the Democratic and the Republican candidates. The Republican candidate is elected mayor. Can Quail deduct any of the political contributions it made?

5. **LO.3** Carmine, Inc., a tobacco manufacturer, incurs certain expenditures associated with political contributions and lobbying activities. Which of these expenditures can be deducted?

Payments to Washington, D.C. law firm to lobby members of Congress	$800,000
Payments to Washington, D.C. law firm to lobby the head of the FDA	25,000
Payments to Richmond law firm to lobby members of the state legislature	50,000
Payments to Lexington law firm to lobby members of the Lexington City Council	5,000
Political contribution to Committee to Reelect the Mayor of Lexington	6,000

ISSUE ID

6. **LO.3** Address the following issues.
   a. Which of the following is a related party under § 267?
      - Father
      - Brother
      - Niece
      - Sister-in-law
      - Cousin
      - Grandson
      - Corporation and a shareholder who owns 59% of the stock
   b. What negative tax consequences can result from being classified as a related party?

7. **LO.3** Jarret owns City of Savannah bonds with an adjusted basis of $100,000. During the year, he receives interest payments of $3,000. Jarret partially financed the purchase of the bonds by borrowing $80,000 at 5% interest. Jarret's interest payments on the loan this year are $4,000, and his principal payments are $900.
   a. Should Jarret report any interest income this year?
   b. Can Jarret deduct any interest expense this year?

8. **LO.1** Drew and his wife Cassie own all of the stock of Thrush, Inc. Cassie is the president and Drew is the vice president. Cassie and Drew are paid salaries of $400,000 and $300,000, respectively, each year. They consider the salaries to be reasonable based on a comparison with salaries paid for comparable positions in comparable companies. They project Thrush's taxable income for next year, before their salaries, to be $800,000. They decide to place their four teenage children on the payroll and to pay them total salaries of $100,000. The children will each work about five hours per week for Thrush.
   a. What are Drew and Cassie trying to achieve by hiring the children?
   b. Calculate the tax consequences of hiring the children on Thrush, Inc., and on Drew and Cassie's family.

9. **LO.3** Edward, an attorney, is hired by a major accounting firm to represent it and clients in dealing with members of the U.S. Congress. The accounting firm is supporting liability reform that would limit the "joint and several" liability of professionals such as attorneys and CPAs. Edward is paid a retainer of $40,000, $50,000 for chargeable time, and reimbursement of $12,500 for meal and entertainment expenses incurred in meeting with members of Congress and their staffs. Which of these payments to Edward can the firm deduct?

10. **LO.3** Judy, the owner of a very successful restaurant chain, is exploring the possibility of expanding the chain into a city in the neighboring state. She incurs $38,000 of expenses associated with this investigation. Based on the regulatory environment for restaurants in the city, she decides not to expand. During the year, she also investigates opening a hotel that will be part of a national hotel chain. Her expenses for this are $54,000. The hotel begins operations on November 1. Determine the amount that Judy can deduct in the current year for investigating these two businesses.

11. **LO.3** Eleanor Saxon sold stock (basis of $65,000) to her brother, Ridge, for $59,000, the fair market value. DECISION MAKING COMMUNICATIONS
   a. What are the tax consequences to Eleanor?
   b. What are the tax consequences to Ridge if he later sells the stock for $72,000? For $52,000? For $64,000?
   c. Write a letter to Eleanor in which you inform her of the tax consequences if she sells the stock to Ridge for $59,000 and explain how a sales transaction could be structured that would produce better tax consequences for her. Eleanor's address is 32 Country Lane, Lawrence, KS 66045.

12. **LO.4** In 2010, Gray Corporation, a calendar year C corporation, holds a $75,000 charitable contribution carryover from a gift made in 2005. Gray is contemplating a gift of land to a qualified charity in either 2010 or 2011. Gray purchased the land as an investment five years ago for $100,000 (current fair market value is $250,000). DECISION MAKING

    Before considering any charitable deduction, Gray projects taxable income of $1 million for 2010 and $1.2 million for 2011. Should Gray make the gift of the land to charity in 2010 or in 2011? Provide support for your answer.

13. **LO.4** Dan Simms is the president and sole shareholder of Simms Corporation, 1121 Madison Street, Seattle, WA 98121. Dan plans for the corporation to make a charitable contribution to the University of Washington, a qualified public charity. He will have the corporation donate Jaybird Corporation stock, held for five years, with a basis of $11,000 and a fair market value of $18,000. Dan projects a $310,000 net profit for Simms Corporation in 2010 and a $90,000 net profit in 2011. Dan calls you on December 13, 2010, and asks whether Simms should make the contribution in 2010 or 2011. Write a letter advising Dan about the timing of the contribution. DECISION MAKING COMMUNICATIONS

14. **LO.5** Blue Corporation, a manufacturing company, decided to develop a new line of merchandise. The project began in 2010. Blue had the following expenses in connection with the project.

	2010	2011
Salaries	$400,000	$500,000
Materials	80,000	90,000
Insurance	10,000	15,000
Utilities	7,000	9,000
Cost of inspection of materials for quality control	5,000	6,000
Promotion expenses	10,000	12,000
Advertising	–0–	30,000
Equipment depreciation	10,000	12,000
Cost of market survey	8,000	–0–

The new product will be introduced for sale beginning in July 2012. Determine the amount of the deduction for research and experimental expenditures for 2010, 2011, and 2012 if:

a. Blue Corporation elects to expense the research and experimental expenditures.
b. Blue Corporation elects to amortize the research and experimental expenditures over 60 months.

15. **LO.5** Sarah Ham, operating as a sole proprietor, manufactures printers in the United States. For 2010, the proprietorship has QPAI of $400,000. Sarah's modified AGI was $290,000. The W–2 wages paid by the proprietorship to employees engaged in the qualified domestic production activity were $50,000. Calculate Sarah's DPAD for 2010.

DECISION MAKING

16. **LO.5** In 2010, Rose, Inc., has QPAI of $4 million and taxable income of $3 million. Rose pays independent contractors $500,000. Rose's W–2 wages are $600,000, but only $400,000 of the wages are paid to employees engaged in qualified domestic production activities.

a. Calculate the DPAD for Rose, Inc., for 2010.
b. What suggestions could you make to enable Rose to increase its DPAD?

17. **LO.6** On November 4, 2008, Blue Company acquired an asset (27.5-year residential real property) for $100,000 for use in its business. In 2008 and 2009, respectively, Blue took $321 and $2,564 of cost recovery. These amounts were incorrect because Blue applied the wrong percentages (i.e., those for 39-year rather than 27.5-year property). Blue should have taken $455 and $3,636 of cost recovery in 2008 and 2009. On January 1, 2010, the asset was sold for $98,000. Calculate the gain or loss on the sale of the asset in 2010.

18. **LO.6** Juan, a sole proprietor, acquires a new five-year class asset on March 14, 2010, for $100,000. This is the only asset acquired by Juan during the year. He does not elect immediate expensing under § 179. If Congress reenacts additional first-year depreciation for 2010, he elects not to take additional first-year depreciation. On July 15, 2011, Juan sells the asset.

a. Determine Juan's cost recovery for 2010.
b. Determine Juan's cost recovery for 2011.

19. **LO.6** On May 5, 2010, Christy purchased and placed in service a hotel. The hotel cost $1.8 million. Calculate Christy's cost recovery for 2010. For 2020.

20. **LO.6** Janice acquired an apartment building on June 4, 2010, for $1.4 million. The value of the land is $200,000. Janice sold the apartment building on November 29, 2016.

a. Determine Janice's cost recovery for 2010.
b. Determine Janice's cost recovery for 2016.

21. **LO.6** During the month of March 2010, Sam constructed agricultural fences on his farm. The cost of the fencing was $70,000. Sam does not elect immediate expensing under § 179, but an election to not have the uniform capitalization rules apply is in effect. Compute Sam's cost recovery for 2010.

22. **LO.6** On January 1, 2003, Jim leased a building to be used in his business as an office building. The lease will terminate on December 31, 2010. On February 2, 2004, Jim made a capital improvement to the building. The cost of the leasehold improvement to Jim was $80,000. Jim has no legal rights in the capital improvement after the termination of the lease. Determine Jim's loss in 2010, if any, with respect to the leasehold improvement as a result of the termination of the lease.

23. **LO.6** On July 10, 2001, Wade purchased and placed in service a warehouse. The warehouse cost $850,000. On May 7, 2010, Wade sold the warehouse. CRITICAL THINKING
    a. Determine Wade's cost recovery for 2001.
    b. Determine Wade's cost recovery for 2010.

24. **LO.6** Lori, who is single, purchased a new copier (five-year class property) for $50,000 and new furniture (seven-year class property) for $275,000 on May 20, 2010. Lori expects the taxable income derived from her business (without regard to the amount expensed under § 179) to be about $400,000. Lori wants to elect immediate § 179 expensing, but she doesn't know which asset she should expense under § 179. If Congress reenacts additional first-year depreciation for 2010, she elects not to take additional first-year depreciation. DECISION MAKING
    a. Determine Lori's total deduction if the § 179 expense is first taken with respect to the copier.
    b. Determine Lori's total deduction if the § 179 expense is first taken with respect to the furniture.
    c. What is your advice to Lori?

25. **LO.6** Olga is the proprietor of a small business. In 2010, the business income, before consideration of any cost recovery or § 179 deduction, is $250,000. Olga spends $850,000 on new seven-year class assets and elects to take the § 179 deduction on them. If Congress reenacts additional first-year depreciation for 2010, she elects not to take additional first-year depreciation. Olga's cost recovery deduction for 2010, except for the cost recovery with respect to the new seven-year assets, is $95,000. Determine Olga's total cost recovery for 2010 with respect to the seven-year class assets and the amount of any § 179 carryforward.

26. **LO.6** On March 10, 2010, Yoon purchased three-year class property for $20,000. On December 15, 2010, he purchased five-year class property for $340,000. Yoon has net business income of $500,000 before consideration of any § 179 deduction. DECISION MAKING
    a. Calculate Yoon's cost recovery for 2010, assuming he does not make the § 179 election or use straight-line cost recovery. If Congress reenacts additional first-year depreciation for 2010, he elects not to take additional first-year depreciation.
    b. Calculate Yoon's cost recovery for 2010, assuming he does elect to use § 179 and does not elect to use straight-line cost recovery. If Congress reenacts additional first-year depreciation for 2010, he elects not to take additional first-year depreciation.
    c. Assuming Yoon's marginal tax rate is 33%, determine his tax benefit from electing § 179.

27. **LO.6** John Johnson is considering acquiring an automobile at the beginning of 2010 that he will use 100% of the time as a taxi. The purchase price of the automobile is $35,000. John has heard of cost recovery limits on automobiles and wants to know the maximum amount of the $35,000 he can deduct in the first year. Write a letter to John in which you present your calculations. Also, prepare a memo for the tax files. John's address is 100 Morningside, Clinton, MS 39058. COMMUNICATIONS

28. **LO.6** On October 15, 2010, Jon purchased and placed in service a new car. The purchase price was $25,000. This was the only business-use asset Jon acquired in 2010. He used the car 80% of the time for business and 20% for personal use. Jon used the statutory percentage method of cost recovery. If Congress reenacts additional first-year depreciation for 2010, he elects not to take additional first-year depreciation. Calculate the total deduction Jon may take for 2010 with respect to the car.

29. **LO.6** On June 5, 2010, Leo purchased and placed in service a new car that cost $20,000. The business-use percentage for the car is always 100%. If Congress reenacts additional first-year depreciation for 2010, he elects not to take additional first-year depreciation. Compute Leo's cost recovery deduction in 2010 and 2011.

30. **LO.6** On May 28, 2010, Mary purchased and placed in service a new $40,000 car. The car was used 60% for business, 20% for production of income, and 20% for personal use in 2010. In 2011, the usage changed to 40% for business, 30% for production of income, CRITICAL THINKING

and 30% for personal use. Mary did not elect immediate expensing under § 179. If Congress reenacts additional first-year depreciation for 2010, she elects not to take additional first-year depreciation. Compute the cost recovery and any cost recovery recapture in 2011.

31. **LO.6** In 2010, Muhammad purchased a new computer for $14,000. The computer is used 100% for business. Muhammad did not make a § 179 election with respect to the computer. If Congress reenacts additional first-year depreciation for 2010, he elects not to take additional first-year depreciation. If Muhammad uses the statutory percentage method, determine his cost recovery deduction for 2010 for computing taxable income and for computing his alternative minimum tax.

DECISION MAKING

32. **LO.6** Jamie purchased $100,000 of new office furniture for her business in June of the current year. Jamie understands that if she elects to use ADS to compute her regular income tax, there will be no difference between the cost recovery for computing the regular income tax and the AMT. Jamie wants to know the *regular* income tax cost, after three years, of using ADS rather than MACRS. Assume that Jamie does not elect § 179 limited expensing and that her marginal tax rate is 28%. If Congress reenacts additional first-year depreciation for 2010, she elects not to take additional first-year depreciation.

DECISION MAKING

COMMUNICATIONS

33. **LO.7** Mike Saxon is negotiating the purchase of a business. The final purchase price has been agreed upon, but the allocation of the purchase price to the assets is still being discussed. Appraisals on a warehouse range from $1,200,000 to $1,500,000. If a value of $1,200,000 is used for the warehouse, the remainder of the purchase price, $800,000, will be allocated to goodwill. If $1,500,000 is allocated to the warehouse, goodwill will be $500,000. Mike wants to know what effect each alternative will have on cost recovery and amortization during the first year. Under the agreement, Mike will take over the business on January 1 of next year. Write a letter to Mike in which you present your calculations and recommendation. Also, prepare a memo for the tax files. Mike's address is 200 Rolling Hills Drive, Shavertown, PA 18708.

ETHICS AND EQUITY

34. **LO.8** Sam Jones owns a granite stone quarry. When he acquired the land, Sam allocated $800,000 of the purchase price to the quarry's recoverable mineral reserves, which were estimated at 10 million tons of granite stone. Based on these estimates, the cost depletion was $.08 per ton. In April of the current year, Sam received a letter from the State Department of Highways notifying him that part of his property was being condemned so the state could build a new road. At that time, the recoverable mineral reserves had an adjusted basis of $600,000 and 7.5 million tons of granite rock. Sam estimates that the land being condemned contains about 2 million tons of granite. Therefore, for the current year, Sam has computed his cost depletion at $.11 [$600,000/(7,500,000 − 2,000,000)] per ton. Evaluate the appropriateness of what Sam is doing.

35. **LO.8** Wes acquired a mineral interest during the year for $10 million. A geological survey estimated that 250,000 tons of the mineral remained in the deposit. During the year, 80,000 tons were mined, and 45,000 tons were sold for $12 million. Other expenses amounted to $5 million. Assuming the mineral depletion rate is 22%, calculate Wes's lowest taxable income.

Bridge DISCIPLINE

1. Sparrow Corporation is considering the acquisition of an asset for use in its business over the next five years. However, Sparrow must decide whether it would be better served by leasing the asset or buying it. An appropriate asset could be purchased for $15,000, and it would qualify as a three-year asset under the MACRS classification. Assume that the election to expense assets under § 179 is not available and that the asset is not expected to have a salvage value at the end of its use by Sparrow. Alternatively, Sparrow could lease the asset for a $3,625 annual cost over the five-year period. If Sparrow is in the 34% tax bracket, would you recommend that Sparrow buy or lease the asset? In your calculations, assume that 10% is an appropriate discount factor.

DECISION MAKING

2. Lark Corporation is considering the acquisition of an asset for use in its business over the next five years. However, Lark must decide whether it would be better served by leasing the asset or buying it. An appropriate asset could be purchased for $15,000, and it would qualify as a three-year asset under the MACRS classification. Assume that the election to expense assets under § 179 is made and that the asset is not

expected to have a salvage value at the end of its use by Lark. Alternatively, Lark could lease the asset for a $3,625 annual cost over the five-year period. If Lark is in the 34% tax bracket, would you recommend that Lark buy or lease the asset? In your calculations, assume that 10% is an appropriate discount factor.

3. Wayside Fruit Company is a sole proprietorship owned by Neil Stephenson. The company's records reflect the following.

Sales revenue	$185,000
Operating expenses	125,000
Depreciation expense for book	13,000
Cost recovery allowance for tax	17,500
Loss on the sale of delivery truck to Neil's brother	5,000
Amount paid to fruit inspector to overlook below-standard fruit shipped to various vendors	3,000

Compute the net income before tax for book purposes and the amount of taxable income for Wayside Fruit Company.

RESEARCH PROBLEMS

Note: Solutions to Research Problems can be prepared by using the **Checkpoint® Student Edition** online research product, which is available to accompany this text. It is also possible to prepare solutions to the Research Problems by using tax research materials found in a standard tax library.

THOMSON REUTERS
Checkpoint® Student Edition

Research Problem 1. Robin, Inc., acquired all the assets of Sparrow, Inc. In addition, Robin assumed certain liabilities of Sparrow. Robin agreed that it would be legally responsible for any judgment in a patent infringement claim being litigated against Sparrow. Experts' opinions indicated that the likelihood that a significant contingent liability would result was remote (i.e., between 0% and 5%).

After a trial, a jury concluded that an illegal patent infringement had occurred, and it awarded a judgment of $5 million. Robin paid the $5 million and deducted it as an ordinary and necessary business expense. Upon audit, the IRS reclassified the $5 million payment and treated it as a capital expenditure under § 263. Evaluate the positions taken by Robin and by the IRS.

Research Problem 2. Rocky Sole, Inc., is in the business of designing, developing, manufacturing, and selling hiking boots. The company's design department activities relate to the design, development, modification, and improvement of Rocky Sole's hiking boots. The department produces drawings containing ideas for new products or improvements on existing products. When agreement is reached on a new design, the department evaluates the appropriate manufacturing process. The design department does no internal testing to determine how the hiking boots will perform.

Evaluate the possibility of Rocky Sole, Inc., claiming some or all of the costs incurred by the design department as research and experimental expenditures under § 174.

Research Problem 3. Red Corporation operates a facility that produces ethanol. The ethanol is produced by the fermentation of starches released from milled biostocks. The primary business purpose for the ethanol is as an alternative fuel source to gasoline. Red Corporation wants to know the appropriate asset class to determine the depreciation deduction for the assets used in the integrated facility for converting corn to ethanol.

Research Problem 4. Juan owns a business that acquires exotic automobiles that are high-tech, state-of-the-art vehicles with unique design features or equipment. The exotic automobiles are not licensed nor are they set up to be used on the road. Rather, the cars are used exclusively for car shows or related promotional photography. Can Juan take a cost recovery deduction with respect to the exotic automobiles on his Federal income tax return? Prepare an outline for your classmates addressing this issue.

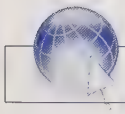
COMMUNICATIONS

Partial list of research aids:
Bruce Selig, 70 TCM 1125, T.C.Memo. 1995–519.

COMMUNICATIONS

Research Problem 5. Acme Motors sells and leases automobiles. Acme administers a leasing program for its employees. The leases are solely for the personal use of the automobile by the employees. The plan does not involve use of the automobile in the employee's employment-related activities for Acme. The lease terminates automatically if the employee (lessee) ceases to be employed by Acme.

The leased vehicles are registered and titled in Acme's name, and Acme pays all of the employees' registration fees, insurance, and maintenance costs. Are the leased vehicles exempt from the "luxury auto" depreciation limitations of § 280F in computing Acme's taxable income? Summarize your findings in an e-mail to your instructor.



INTERNET *activity*

Use the tax resources of the Internet to address the following questions. Do not restrict your search to the Web, but include a review of newsgroups and general reference materials, practitioner sites and resources, primary sources of the tax law, chat rooms and discussion groups, and other opportunities.

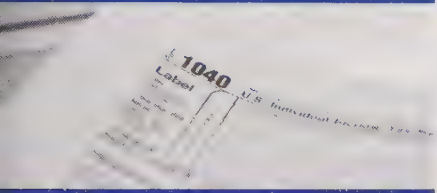
Research Problem 6. The $1 million maximum compensation deduction does not seem to have deterred large corporations from remunerating their executives at very high levels. What techniques are being used by tax advisers and employers to work around the millionaires' provision? Are executives taking pay cuts, or are their salaries being deferred or changed in nature due to § 162(m)?

COMMUNICATIONS

Research Problem 7. Changes to depreciation systems often are discussed by policy makers and observers of the tax system. In no more than three PowerPoint slides, outline the terms and policy objectives of one of the changes currently proposed by the Treasury, a member of Congress, or a tax policy think tank.

CHAPTER 6

Losses and Loss Limitations



LEARNING OBJECTIVES

After completing Chapter 6, you should be able to:

LO.1 Determine the amount, classification, and timing of the **bad debt deduction**. **(pp. 6-3 to 6-6)**

LO.2 Understand the tax treatment of **worthless securities** including § 1244 stock. **(pp. 6-6 to 6-7)**

LO.3 Identify a casualty and determine the amount, classification, and timing of **casualty and theft losses**. **(pp. 6-7 to 6-12)**

LO.4 Recognize the impact of the **net operating loss** carryback and carryover provisions. **(pp. 6-12 to 6-14)**

LO.5 Discuss tax shelters and the **reasons for at-risk and passive loss limitations**. **(pp. 6-14 to 6-16)**

LO.6 Describe **how the at-risk limitation and the passive loss rules limit deductions** for losses and identify taxpayers subject to these restrictions. **(pp. 6-16 to 6-23)**

LO.7 Discuss and be able to apply the **definitions of activity, material participation, and rental activity** under the passive loss rules. **(pp. 6-23 to 6-29)**

LO.8 Recognize the **relationship between the at-risk and passive activity limitations**. **(pp. 6-29 to 6-30)**

LO.9 Discuss the special treatment available to **real estate activities**. **(pp. 6-30 to 6-33)**

LO.10 Determine the **consequences of the disposition of passive activities**. **(pp. 6-33 to 6-35)**

TAX *Talk*

The income tax has made more liars out of the American people than golf has. Even when you make a tax form out on the level, you don't know when it's through if you are a crook or a martyr.

—Will Rogers

OUTLINE

6.1 Bad Debts, 6-3
Specific Charge-Off Method, 6-3
Business versus Nonbusiness Bad Debts, 6-4
Loans between Related Parties, 6-5
6.2 Worthless Securities, 6-6
Small Business Stock, 6-6
6.3 Casualty and Theft Losses, 6-7
Definition of Casualty, 6-7
Definition of Theft, 6-8
When to Deduct Casualty Losses, 6-8
Measuring the Amount of Loss, 6-9
Casualty and Theft Losses of Individuals, 6-11
6.4 Net Operating Losses, 6-12
Introduction, 6-12
Carryback and Carryover Periods, 6-13
6.5 The Tax Shelter Problem, 6-14
6.6 At-Risk Limitations, 6-16
6.7 Passive Loss Limits, 6-18
Classification and Impact of Passive Income and Loss, 6-18
Taxpayers Subject to the Passive Loss Rules, 6-21
Activity Defined, 6-23
Material Participation, 6-24
Rental Activities, 6-28
Interaction of At-Risk and Passive Activity Limits, 6-29
Special Rules for Real Estate, 6-30
Disposition of Passive Activities, 6-33

THE BIG PICTURE Tax Solutions for the Real World

RECEIVING TAX BENEFITS FROM LOSSES

Robyn is nearing the end of a year that she would like to forget. Several years ago, she loaned a friend $25,000 to enable him to start a business. The friend had made scheduled payments of $7,000 (including $1,000 of interest) when he suddenly died in January. At the time of his death, he was insolvent, and Robyn's attempts to collect the debt were fruitless.

Two years ago, Robyn invested $60,000 by purchasing stock of a closely held small business corporation started by her brother. However, the company declared bankruptcy in May of this year, and Robyn was notified by the bankruptcy trustee that she can expect to receive nothing from the company.

Robyn has owned and operated a bookstore as a sole proprietorship for the past 10 years. The bookstore previously has been profitable and produced annual taxable income of approximately $75,000. However, due to the downturn in the economy, the business lost $180,000 this year.

In September, a tornado caused a large oak tree to blow over onto Robyn's house. The cost of removing the tree and making repairs to the house was $32,000. Robyn received a check for $25,000 from her insurance company. Her adjusted basis for the house was $280,000.

Finally, Robyn invested $20,000 for a 10 percent interest in a limited partnership that owns and operates orange groves in Florida. Due to a hard freeze that damaged much of the fruit, the partnership lost $200,000 and allocated $20,000 of ordinary loss to Robyn.

Robyn comes to you for tax advice and would like to know the tax ramifications of each of the transactions listed above. **Read the chapter and formulate your response.**

Chapter 5 introduced rules governing the deductibility of trade or business expenses. This chapter extends the notion of deductibility to losses occurring in the course of business operations. In particular, special rules concerning the tax treatment of bad debts, casualty losses, and operating losses are reviewed. In addition, tax shelters and the rules that limit their usefulness as tax avoidance devices are discussed.



JUST HOW GOOD IS YOUR CREDIT?

To be successful, a business must generate sales among customers who are willing and able to pay their obligations. Nonetheless, if a sale is made and it is determined that the related account receivable is uncollectible, an accrual method business is allowed to claim a bad debt deduction. Recently, corporations claimed bad debt deductions of approximately $106 billion against business receipts of about $23.3 trillion.

Source: 2006 Corporation Returns—Returns of Active Corporations; Table 2—Balance Sheet, Income Statement, and Selected Other Items, by Size of Total Assets; 2009.

6.1 BAD DEBTS

LO.1

Determine the amount, classification, and timing of the bad debt deduction.

If a taxpayer lends money or purchases a debt instrument and the debt is not repaid, a **bad debt** deduction is allowed. Similarly, if an accrual basis taxpayer sells goods or provides services on credit and the account receivable subsequently becomes worthless, a bad debt deduction is permitted.[1] No deduction is allowed, however, for a bad debt arising from the sale of a product or service when the taxpayer is on the cash basis because no income is reported until the cash has been collected. Permitting a bad debt deduction for a cash basis taxpayer would amount to a double deduction because the expenses of the product or service rendered are deducted when payments are made to suppliers and to employees or at the time of the sale.

EXAMPLE 1

Ella, a sole proprietor engaged in the practice of accounting, performed services for Pat for which she charged $8,000. Pat never paid the bill, and his whereabouts are unknown.

If Ella is an accrual basis taxpayer, she includes the $8,000 in income when the services are performed. When she determines that Pat's account will not be collected, she deducts the $8,000 as a bad debt.

If Ella is a cash basis taxpayer, she does not include the $8,000 in income until payment is received. When she determines that Pat's account will not be collected, she cannot deduct the $8,000 as a bad debt expense because it was never recognized as income. ■

SPECIFIC CHARGE-OFF METHOD

Most taxpayers are required to use the **specific charge-off method** when accounting for bad debts. Some financial institutions are permitted to use an alternative **reserve method** for computing bad debt deductions.

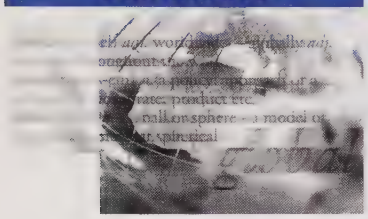
A taxpayer using the specific charge-off method may claim a deduction when a specific *business* debt becomes either partially or wholly worthless or when a specific *nonbusiness* debt becomes wholly worthless.[2] For a business debt, the taxpayer must satisfy the IRS that the debt is partially worthless and must demonstrate the amount of worthlessness. If a business debt previously deducted as partially worthless becomes totally worthless in a future year, only the remainder not previously deducted can be deducted in the future year.

In the case of total worthlessness, a deduction is allowed for the entire amount in the year that the debt becomes worthless. The amount of the deduction depends on the taxpayer's basis in the bad debt. If the debt arose from the sale of services or products and the face amount was previously included in income, that amount is

[1] Reg. § 1.166–1(e).

[2] § 166(a) and Reg. § 1.166.

GLOBAL *Tax Issues*



Applying the Tax Benefit Rule

As the Philippine economy feels the effects of the global financial crisis, bad debts or the recovery of bad debts written off in prior years can be expected. When these transactions occur, taxpayers should consider the tax benefit rule in determining the tax impact of the transactions. When a bad debt previously deducted is subsequently recovered, it should be included in taxable income to the extent of the tax benefit of the deduction. If there was no tax benefit from the deduction, a subsequent recovery should be treated as a tax-free recovery or return of capital.

Source: Adapted from Victoria Marie Domini M. Comia, "Taxwise or Otherwise," *Business World (Manila)*, April 2, 2009.

deductible. If the taxpayer purchased the debt, the deduction equals the amount the taxpayer paid for the debt instrument.

Determining when a bad debt becomes worthless can be a difficult task. Legal proceedings need not be initiated against the debtor when the surrounding facts indicate that such action will not result in collection.

EXAMPLE 1

In 2008, Partridge Company lent $1,000 to Kay, who agreed to repay the loan in two years. In 2010, Kay disappeared after the note became delinquent. If a reasonable investigation by Partridge indicates that Kay cannot be found or that a suit against Kay would not result in collection, Partridge can deduct the $1,000 in 2010. ■

Bankruptcy is generally an indication of at least partial worthlessness of a debt. Bankruptcy may create worthlessness before the settlement date. If this is the case, the deduction may be taken in the year of worthlessness.

EXAMPLE 2

In Example 2, assume that Kay filed for personal bankruptcy in 2009 and that the debt is a business debt. At that time, Partridge learned that unsecured creditors (including Partridge) were ultimately expected to receive 20 cents on the dollar. In 2010, settlement is made and Partridge receives only $150. Partridge should deduct $800 ($1,000 loan − $200 expected settlement) in 2009 and $50 in 2010 ($200 balance − $150 proceeds). ■

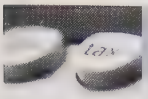
If a receivable is written off (deducted) as uncollectible and is subsequently collected during the same tax year, the write-off entry is reversed. If a receivable has been written off (deducted) as uncollectible, collection in a later tax year may result in income being recognized. Income will result if the deduction yielded a tax benefit in the year it was taken (the tax benefit rule).

BUSINESS VERSUS NONBUSINESS BAD DEBTS

The nature of a debt depends upon whether the lender is engaged in the business of lending money or whether there is a proximate relationship between the creation of the debt and the *lender's* trade or business. Where either of these conditions is true, a bad debt is classified as a **business bad debt**. If these conditions are not met, a bad debt is classified as a **nonbusiness bad debt**. The use to which the borrowed funds are put is of no consequence when making this classification decision.

EXAMPLE 3

Jamil lent his friend, Esther, $1,500. Esther used the money to start a business, which subsequently failed. Even though the proceeds of the loan were used in a business, the loan is a nonbusiness bad debt, because the business was Esther's, and not Jamil's. ■



CONCEPT SUMMARY 6.1

The Tax Treatment of Bad Debts Using the Specific Charge-Off Method

	Business Bad Debts	Nonbusiness Bad Debts
Timing of deduction	A deduction is allowed when the debt becomes either partially or wholly worthless.	A deduction is allowed *only* when the debt becomes wholly worthless.
Character of deduction	The bad debt may be deducted as an ordinary loss.	The bad debt is classified as a short-term capital loss, subject to the $3,000 capital loss limitation for individuals.
Recovery of amounts previously deducted	If the account recovered was written off during the current tax year, the write-off entry is reversed. If the account was written off in a previous tax year, income is created subject to the tax benefit rule.	If the account recovered was written off during the current tax year, the write-off entry is reversed. If the account was written off in a previous tax year, income is created subject to the tax benefit rule.

EXAMPLE 5

Horace operates a sole proprietorship that sells premium stereo equipment. Horace uses the accrual basis to account for sales of the stereo equipment. During the year, he sold a $4,000 stereo system to Herbie on credit. Later that year, the account receivable becomes worthless. The loan is a business bad debt, because the debt was related to Horace's business. ■

Generally, nonbusiness bad debts are incurred only by individuals. It is assumed that any loans made by a corporation are related to its trade or business. Therefore, any bad debts resulting from loans made by a corporation are automatically business bad debts.

The distinction between a business bad debt and a nonbusiness bad debt is important. A business bad debt is deductible as an ordinary loss in the year incurred, whereas a nonbusiness bad debt is always treated as a short-term capital loss. Thus, regardless of the age of a nonbusiness bad debt, the deduction may be of limited benefit due to the $3,000 capital loss limitation for individuals (refer to the discussion in Chapter 4).

LOANS BETWEEN RELATED PARTIES

Loans between related parties raise the issue of whether the transaction was a *bona fide* loan or some other transfer, such as a gift, a disguised dividend payment, or a contribution to capital. The Regulations state that a bona fide debt arises from a debtor-creditor relationship based on a valid and enforceable obligation to pay a fixed or determinable sum of money. Thus, individual circumstances must be examined to determine whether advances between related parties are loans. Some considerations are these:

- Was a note properly executed?
- Was there a reasonable rate of interest?
- Was collateral provided?
- What collection efforts were made?
- What was the intent of the parties?

EXAMPLE 6

Ted, who is the sole shareholder of Penguin Corporation, lends the corporation $10,000 so that it can continue business operations. The note specifies a 2% interest rate and is payable on demand. Penguin has shown losses in each year of its five-year

existence. The corporation also has liabilities greatly in excess of its assets. It is likely that Ted's transfer to the corporation would be treated as a contribution to capital rather than a liability. Consequently, no bad debt deduction would be allowed upon default by Penguin. ■

6.2 Worthless Securities

LO.2

Understand the tax treatment of worthless securities including § 1244 stock.

A loss is allowed for securities that become *completely* worthless during the year (**worthless securities**).[3] Such securities are shares of stock, bonds, notes, or other evidence of indebtedness issued by a corporation or government. The losses generated are treated as capital losses (refer to Chapter 4) deemed to have occurred on the *last day* of the tax year. By treating losses as having occurred on the last day of the tax year, a loss that would otherwise have been classified as short term (if the date of worthlessness were used) may be classified as long term.

EXAMPLE 7

Falcon Company, a calendar year taxpayer, owns stock in Owl Corporation (a publicly held company). The stock was acquired as an investment on May 31, 2009, at a cost of $5,000. On April 1, 2010, the stock became worthless. Because the stock is deemed to have become worthless as of December 31, 2010, Falcon has a capital loss from an asset held for 19 months (a long-term capital loss). ■

SMALL BUSINESS STOCK

The general rule is that shareholders receive capital loss treatment for losses from the sale or exchange of corporate stock. As noted in Chapter 4, the deductibility of capital losses is limited. However, it is possible to avoid capital loss limitations if the loss is sustained on **small business stock (§ 1244 stock)**. Such a loss could arise from a sale of the stock or from the stock becoming worthless. Only *individuals*[4] who acquired the stock *from* the issuing corporation are eligible to receive ordinary loss treatment under § 1244. The ordinary loss treatment is limited to $50,000 ($100,000 for married individuals filing jointly) per year. Losses on § 1244 stock in excess of the statutory limits are treated as capital losses.

The issuing corporation must meet certain requirements for the loss on § 1244 stock to be treated as an *ordinary*—rather than a capital—loss. The principal requirement is that the total capitalization of the corporation is limited to a maximum of $1 million. This capital limit includes all money and other property received by the corporation for stock and all capital contributions made to the corporation. The $1 million test is made at the time the stock is issued. There are no requirements regarding the kind of stock issued. Section 1244 stock can be either common or preferred.

Section 1244 applies only to losses. If § 1244 stock is sold at a gain, the provision does not apply, and the gain is capital gain (which, for individuals, may be subject to preferential tax treatment, as discussed in Chapter 4).

EXAMPLE 8

On July 1, 2008, Iris, a single individual, purchased 100 shares of Eagle Corporation common stock for $100,000. The Eagle stock qualifies as § 1244 stock. On June 20, 2010, Iris sells all of the Eagle stock for $20,000, which results in a loss of $80,000. Because the Eagle stock is § 1244 stock, Iris has $50,000 of ordinary loss and $30,000 of long-term capital loss. ■

[3] § 165(g).

[4] The term *individuals* for this purpose includes a partnership but not a trust or an estate.

Tax Planning Strategies MAXIMIZING THE BENEFITS OF § 1244

FRAMEWORK FOCUS: TAX RATE

Strategy: Control the Character of Income and Deductions.

Because § 1244 limits the amount of loss classified as ordinary loss on a yearly basis, a taxpayer might maximize the benefits of § 1244 by selling the stock in more than one taxable year.

EXAMPLE 9

Mitch, a single individual, purchased small business stock in 2008 for $150,000 (150 shares at $1,000 per share). On December 20, 2010, the stock is worth $60,000 (150 shares at $400 per share). Mitch wants to sell the stock at this time. He earns a salary of $80,000 a year, has no other capital transactions, and does not expect any in the future. If Mitch sells all of the small business stock in 2010, his recognized loss will be $90,000 ($60,000 selling price − $150,000 cost). The loss will be characterized as a $50,000 ordinary loss and a $40,000 long-term capital loss. In computing taxable income for 2010, Mitch could deduct the $50,000 ordinary loss but could deduct only $3,000 of the capital loss (assuming he has no capital gains). The remainder of the capital loss could be carried over and used in future years subject to the capital loss limitations.

Alternatively, if Mitch sells 82 shares in 2010, he will recognize an ordinary loss of $49,200 [82 × ($400 − $1,000)]. If Mitch then sells the remainder of the shares in 2011, he will recognize an ordinary loss of $40,800 [68 × ($400 − $1,000)], successfully avoiding the capital loss limitation. Mitch could deduct the $49,200 ordinary loss in computing 2010 taxable income and the $40,800 ordinary loss in computing 2011 taxable income. ■

6.3 CASUALTY AND THEFT LOSSES

LO.3

Identify a casualty and determine the amount, classification, and timing of casualty and theft losses.

Losses on business property are deductible, whether attributable to casualty, theft, or some other cause (e.g., rust, termite damage). While all *business* property losses are generally deductible, the amount and timing of casualty and theft losses are determined using special rules. Furthermore, for individual taxpayers, who may deduct casualty losses on personal-use (nonbusiness) property as well as on business and investment property (held in partnerships and S corporations or in an individual capacity), a set of special limitations applies. Casualty gains are also afforded special consideration in the tax law.

DEFINITION OF CASUALTY

The term *casualty* generally includes *fire, storm, shipwreck,* and *theft.* In addition, losses from *other casualties* are deductible. Such losses generally include any loss resulting from an event that is (1) identifiable; (2) damaging to property; and (3) sudden, unexpected, and unusual in nature. The term also includes accidental loss of property provided the loss qualifies under the same rules as any other casualty.

A *sudden event* is one that is swift and precipitous and not gradual or progressive. An *unexpected event* is one that is ordinarily unanticipated and occurs without the intent of the taxpayer who suffers the loss. An *unusual event* is one that is extraordinary and nonrecurring and does not commonly occur during the activity in which the taxpayer was engaged when the destruction occurred.[5] Examples include hurricanes, tornadoes, floods, storms, shipwrecks, fires, sonic booms, vandalism, and mine cave-ins. A taxpayer also can take a deduction for a casualty loss from an automobile accident if the accident is not attributable to the taxpayer's willful act or willful negligence. Weather that causes damage (drought, for example) must be unusual and severe for the particular region to qualify as a casualty. Furthermore, damage must be to the *taxpayer's* property to be deductible.

[5]Rev.Rul. 72–592, 1972–2 C.B. 101.

Events That Are Not Casualties

Not all acts of God are treated as **casualty losses** for income tax purposes. Because a casualty must be sudden, unexpected, and unusual, progressive deterioration (such as erosion due to wind or rain) is not a casualty because it does not meet the suddenness test.

An example of an event that generally does not qualify as a casualty is insect damage. When termites caused damage over a period of several years, some courts have disallowed a casualty loss deduction.[6] On the other hand, some courts have held that termite damage over periods of up to 15 months after infestation constituted a sudden event and was, therefore, deductible as a casualty loss.[7] Despite the existence of some judicial support for the deductibility of termite damage as a casualty loss, the current position of the IRS is that termite damage is not deductible.[8]

Other examples of events that are not casualties are losses resulting from a decline in value rather than an actual loss of the property. For example, a taxpayer was allowed a loss for the actual flood damage to his property but not for the decline in market value due to the property being flood-prone.[9] Similarly, a decline in value of an office building due to fire damage to nearby buildings is not deductible as a casualty.

DEFINITION OF THEFT

Theft includes, but is not necessarily limited to, larceny, embezzlement, and robbery.[10] Theft does not include misplaced items.[11]

Theft losses are treated like other casualty losses, but the *timing* of recognition of the loss differs. A theft loss is deducted in the *year of discovery*, not the year of the theft (unless, of course, the discovery occurs in the same year as the theft). If, in the year of the discovery, a claim exists (e.g., against an insurance company) and there is a reasonable expectation of recovering the adjusted basis of the asset from the insurance company, no deduction is permitted.[12] If, in the year of settlement, the recovery is less than the asset's adjusted basis, a deduction may be available. If the recovery is greater than the asset's adjusted basis, *casualty gain* may be recognized.

EXAMPLE 10

Sakura, Inc., owned a computer that was stolen from its offices in December 2009. The theft was discovered on June 3, 2010, and the corporation filed a claim with its insurance company that was settled on January 30, 2011. Assuming there is a reasonable expectation of full recovery, no deduction is allowed in 2010. A deduction may be available in 2011 if the actual insurance proceeds are less than the adjusted basis of the asset. (Loss measurement rules are discussed later in this chapter.) ■

WHEN TO DEDUCT CASUALTY LOSSES

General Rule

Generally, a casualty loss is deducted in the year the loss occurs. However, no casualty loss is permitted if a reimbursement claim with a reasonable *prospect of full recovery* exists.[13] If the taxpayer has a partial claim, only part of the loss can be claimed in the year of the casualty, and the remainder is deducted in the year the claim is settled.

EXAMPLE 11

Fuchsia Corporation's new warehouse was completely destroyed by fire in 2010. Its cost and fair market value were $250,000. Fuchsia's only claim against the insurance company was on a $70,000 policy and was not settled by year-end. The following year, 2011, Fuchsia settled with the insurance company for $60,000. Fuchsia is entitled to a $180,000 deduction in 2010 and a $10,000 deduction in 2011. ■

[6] *Fay v. Helvering*, 41–2 USTC ¶9494, 27 AFTR 432, 120 F.2d 253 (CA–2, 1941); *U.S. v. Rogers*, 41–1 USTC ¶9442, 27 AFTR 423, 120 F.2d 244 (CA–9, 1941).

[7] *Rosenberg v. Comm.*, 52–2 USTC ¶9377, 42 AFTR 303, 198 F.2d 46 (CA–8, 1952); *Shopmaker v. U.S.*, 54–1 USTC ¶9195, 45 AFTR 758, 119 F.Supp. 705 (D.Ct. Mo., 1953)

[8] Rev.Rul. 63–232, 1963–2 C.B. 97.

[9] *S. L. Solomon*, 39 TCM 1282, T.C.Memo. 1980–87.

[10] Reg. § 1.165–8(d).

[11] *Mary Francis Allen*, 16 T.C. 163 (1951).

[12] Reg. §§ 1.165–1(d)(2) and 1.165–8(a)(2).

[13] Reg. § 1.165–1(d)(2)(i).

Tax Planning Strategies DOCUMENTATION OF RELATED-TAXPAYER LOANS, CASUALTY LOSSES, AND THEFT LOSSES

FRAMEWORK FOCUS: DEDUCTIONS

Strategy: Maximize Deductible Amounts.

Since the validity of loans between related taxpayers might be questioned, adequate documentation is needed to substantiate a bad debt deduction if the loan subsequently becomes worthless. Documentation should include proper execution of the note (legal form) and the establishment of a bona fide purpose for the loan. In addition, it is desirable to stipulate a reasonable rate of interest and a fixed maturity date.

Because a theft loss deduction is not permitted for misplaced items, a police report and evidence of the value of the property (e.g., appraisals, pictures of the property, purchase receipts) are necessary to document a theft.

Similar documentation of the value of property should be provided to support a casualty loss deduction because the amount of loss is measured, in part, by the decline in fair market value of the property.

If a taxpayer receives reimbursement for a casualty loss sustained and deducted in a previous year, an amended return is not filed for that year. Instead, the taxpayer must include the reimbursement in gross income on the return for the year in which it is received to the extent that the previous deduction resulted in a tax benefit (refer to Chapter 4).

EXAMPLE 13

Golden Hawk, Inc., had a deductible casualty loss of $15,000 on its 2009 tax return. Golden Hawk's taxable income for 2009 was $60,000 after deducting the $15,000 loss. In June 2010, the corporation is reimbursed $13,000 for the prior year's casualty loss. Golden Hawk includes the entire $13,000 in gross income for 2010 because the deduction in 2009 produced a tax benefit. ■

Disaster Area Losses

An exception to the general rule for the time of deduction is allowed for **disaster area losses**, which are casualties or disaster-related business losses sustained in an area designated as a disaster area by the President of the United States.[14] In such cases, the taxpayer may *elect* to treat the loss as having occurred in the taxable year immediately *preceding* the taxable year in which the disaster actually occurred. The rationale for this exception is to provide immediate relief to disaster victims in the form of accelerated tax benefits.

If the due date, plus extensions, for the prior year's return has not passed, a taxpayer makes the election to claim the disaster area loss on the prior year's tax return. If a disaster area is designated after the prior year's return has been filed, it is necessary to file either an amended return or a refund claim. In any case, the taxpayer must show clearly that such an election is being made.

MEASURING THE AMOUNT OF LOSS

Amount of Loss

The rules for determining the amount of a loss depend in part on whether business, investment, or personal-use (nonbusiness) property was involved. Another factor that must be considered is whether the property was partially or completely destroyed.

[14] § 165(h).

If business property or investment property (e.g., rental property) is *completely destroyed*, the loss is equal to the adjusted basis[15] (typically cost less depreciation) of the property at the time of destruction.

EXAMPLE 13

Monty's Movers owned a truck, which was used only for business purposes. The truck was destroyed by fire. Monty, the proprietor, had unintentionally allowed his insurance coverage to expire. The fair market value of the truck was $39,000 at the time of the fire, and its adjusted basis was $40,000. Monty is allowed a loss deduction of $40,000 (the adjusted basis of the truck). ■

A different measurement rule applies for *partial destruction* of business and investment property and for *partial* or *complete destruction* of personal-use property held by individuals. In these situations, the loss is the *lesser* of:

- the adjusted basis of the property, or
- the difference between the fair market value of the property before the event and the fair market value immediately after the event.

EXAMPLE 14

Wynd and Rain, a law firm, owned an airplane that was used only for business purposes. The airplane was damaged in an accident. At the date of the accident, the fair market value of the plane was $52,000, and its adjusted basis was $32,000. After the accident, the plane was appraised at $24,000. The law firm's loss deduction is $28,000 (the lesser of the adjusted basis or the decrease in fair market value). ■

Any insurance recovery reduces the loss for business, investment, and personal-use losses. In fact, a taxpayer may realize a gain if the insurance proceeds exceed the adjusted basis of the property. Chapter 8 discusses the treatment of net gains and losses on business property and income-producing property.

A special rule on insurance recovery applies to *personal-use property*. In particular, individuals are not permitted to deduct a casualty loss for damage to insured personal-use property unless an insurance claim is filed. This rule applies, whether the insurance provides partial or full reimbursement for the loss.[16]

Generally, an appraisal before and after the casualty is needed to measure the amount of loss. However, the *cost of repairs* to the damaged property generally is acceptable as a method of establishing the loss in value.[17]

DIGGING DEEPER 1

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

Multiple Losses

When multiple casualty losses occur during the year, the amount of each loss is computed separately. The rules for computing loss deductions where multiple losses have occurred are illustrated in Example 15.

EXAMPLE 15

During the year, Swan Enterprises had the following business casualty losses:

		Fair Market Value of the Asset		
Asset	Adjusted Basis	Before the Casualty	After the Casualty	Insurance Recovery
A	$900	$600	$–0–	$400
B	300	800	250	150

[15]See Chapter 7 for a detailed discussion of basis rules.
[16]§ 165(h)(4)(E).
[17]Reg. § 1.165–7(a)(2)(ii).



6.2 Casualty Gains and Losses

	Business-Use or Income-Producing Property	Personal-Use Property
Event creating the loss	Any event.	Casualty or theft.
Amount	The lesser of the decline in fair market value or the adjusted basis, but always the adjusted basis if the property is totally destroyed.	The lesser of the decline in fair market value or the adjusted basis.
Insurance	Insurance proceeds received reduce the amount of the loss.	Insurance proceeds received (or for which there is an unfiled claim) reduce the amount of the loss.
$100 floor ($500 in 2009)	Not applicable.	Applicable per event.
Gains and losses	Gains and losses are netted (see detailed discussion in Chapter 8).	Personal casualty and theft gains and losses are netted.
Gains exceeding losses		The gains and losses are treated as gains and losses from the sale of capital assets.
Losses exceeding gains		The gains—and the losses to the extent of gains—are treated as ordinary items in computing AGI. The losses in excess of gains, to the extent that they exceed 10% of AGI, are itemized deductions (*from* AGI).

The following losses are allowed:

- Asset A: $500. The complete destruction of a business asset results in a deduction of the adjusted basis of the property (reduced by any insurance recovery) regardless of the asset's fair market value.
- Asset B: $150. The partial destruction of a business asset results in a deduction equal to the lesser of the adjusted basis ($300) or the decline in value ($550), reduced by any insurance recovery ($150). ■

CASUALTY AND THEFT LOSSES OF INDIVIDUALS

Recall from Chapter 4 that the individual income tax formula distinguishes between deductions *for* AGI and deductions *from* AGI. Casualty and theft losses incurred by an individual in connection with a business or with rental and royalty activities are deductible *for* AGI and are limited only by the rules previously discussed.[18] Losses from most other investment activities and personal-use losses are generally deducted *from* AGI. Investment casualty and theft losses (e.g., the theft of a security) are classified as other miscellaneous itemized deductions (not subject to a 2 percent-of-AGI floor as explained in Chapter 16). Casualty and theft losses of personal-use property are subject to special limitations discussed below.

Personal-Use Property

In addition to the valuation rules discussed above, casualty and theft loss deductions from personal-use property must be reduced by a $100 ($500 in 2009) *per event* floor and a 10 percent-of-AGI *aggregate* floor.[19] The $100 ($500 in 2009)

[18] § 62(a)(1).

[19] §§ 165(c)(3) and (h).

TAX ... THE UTILITY OF THE NOL DEDUCTION

Recently, corporations claimed net operating loss deductions of approximately $162.8 billion against business receipts of about $23.3 trillion.

Sources: 2006 Corporation Returns—Returns of Active Corporations; Table 2—Balance Sheet, Income Statement, and Selected Other Items, by Size of Total Assets and Table 20—Tax Items: Number of Returns by Selected Types of Tax, Dividend Items, Net Income or Deficit, Statutory Special Deductions, Income Subject to Tax, Taxes, Credits, and Payments, by Selected Sectors; Summer 2009.

floor applies separately to each casualty or theft and applies to the entire loss from each casualty or theft (e.g., if a storm damages both a taxpayer's residence and automobile, only $100 ($500 in 2009) is subtracted from the total amount of the loss). All personal-use losses incurred during the year are then added together, and the total is reduced by 10 percent of the taxpayer's AGI. The resulting amount is the taxpayer's itemized deduction for personal-use casualty and theft losses.

EXAMPLE 10

Rocky, who had AGI of $30,000, was involved in a motorcycle accident in 2010. His motorcycle, which was used only for personal use and had a fair market value of $12,000 and an adjusted basis of $9,000, was completely destroyed. He received $5,000 from his insurance company. Rocky's casualty loss deduction is $900 [$9,000 basis − $5,000 insurance − $100 floor − $3,000 (.10 × $30,000 AGI)]. The $900 casualty loss is an itemized deduction (*from* AGI). ■

Where there are both casualty and theft gains and losses from personal-use property, special netting rules apply. Generally, if casualty and theft gains exceed losses during the year, the gains and losses are treated as capital gains and losses. Alternatively, if losses exceed gains, the casualty and theft gains (and losses to the extent of gains) are treated as ordinary gains and losses. Any excess losses are deductible as personal-use casualty and theft losses.

DIGGING DEEPER 2

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

6.4 NET OPERATING LOSSES

LO.4

Recognize the impact of the net operating loss carryback and carryover provisions.

INTRODUCTION

The requirement that every taxpayer file an annual income tax return (whether on a calendar year or a fiscal year) can lead to inequities for taxpayers who experience uneven income over a series of years. These inequities result from the application of progressive tax rates to taxable income determined on an annual basis.

EXAMPLE 11

Orange, Inc., realizes the following taxable income or loss over a five-year period: Year 1, $50,000; Year 2, ($30,000); Year 3, $100,000; Year 4, ($200,000); and Year 5, $380,000. Blue Corporation has taxable income of $60,000 every year. Note that both corporations have total taxable income of $300,000 over the five-year period. Assume there is no provision for carryback or carryover of net operating losses. Orange and Blue would have the following five-year tax liabilities:

TAX in the NEWS

A Proposal for Changing the Casualty Loss Limits

On July 24, 2008, Senate Finance Committee Chairman Max Baucus introduced legislation aimed at promoting American jobs, developing clean energy, and providing families with targeted tax relief and incentives. Under the proposal, the 10 percent-of-AGI rule for casualty losses would be waived, and the $100 floor would be permanently raised to $500. The bill would also allow nonitemizers to take the loss as an addition to the standard deduction. To date, this bill has not become law. Since Baucus chairs the Senate Finance Committee, it will be interesting to see if it is enacted eventually.

Source: Adapted from U.S. Senate Documents.

Year	Orange's Tax	Blue's Tax
1	$ 7,500	$10,000
2	–0–	10,000
3	22,250	10,000
4	–0–	10,000
5	129,200	10,000
	$158,950	$50,000

The computation of tax is made without regard to any NOL benefit. Rates applicable to 2010 are used to compute the tax.

Even though Orange and Blue realized the same total taxable income ($300,000) over the five-year period, Orange would have to pay taxes of $158,950, while Blue would pay taxes of only $50,000. ■

To provide partial relief from this inequitable tax treatment, a deduction is allowed for **net operating losses (NOLs)**.[20] This provision permits an NOL for any one year to offset taxable income in other years. The NOL provision provides relief only for losses from the operation of a trade or business or from casualty and theft.

Only C corporations and individuals are permitted an NOL deduction, since losses of partnerships and S corporations pass through to their owners. For C corporations, the NOL equals any negative taxable income for the year, with an adjustment for the dividends received deduction (see Chapter 9). In addition, deductions for prior-year NOLs are not allowed when determining a current-year NOL.

NOLs of individuals are computed by adding back to negative taxable income the excess of nonbusiness deductions (deductions not attributable to, or derived from, a taxpayer's trade or business such as the standard deduction, charitable contributions, and alimony payments) over nonbusiness income (income not attributable to, or derived from, a taxpayer's trade or business such as dividends and alimony received), personal and dependency exemptions, and any net capital loss deducted in calculating taxable income. Business deductions that are allowed for determining the NOL include moving expenses, losses on rental property, loss on the sale of small business stock, one-half of the self-employment tax (refer to Chapter 1), and losses from a sole proprietorship, partnership, or S corporation.

CARRYBACK AND CARRYOVER PERIODS

General Rules

A current-year NOL is usually carried back and deducted against income over the two preceding tax years.[21] It is carried back first to the second year before the loss year and

[20] § 172.

[21] A three-year carryback period is available for any portion of an individual's NOL resulting from a casualty or theft loss. The three-year carryback rule also applies to NOLs that are attributable to presidentially declared disaster areas that are incurred by a small business. For purposes of this provision, a small business is one whose average annual gross receipts for a three-year period are $5 million or less. See § 172(b)(1)(F). Tax legislation enacted in 2009 and 2010 enables businesses to carry back NOLs incurred in 2008 or 2009, but not both, three, four, or five years.

TAX in the NEWS

Tax Savings from NOLs

Delta Airlines reported earnings of $155 million from operations for the first quarter of 2007. This was the last full quarter before the airline emerged from Chapter 11 bankruptcy protection. CEO Gerald Grinstein estimated that pretax earnings would be $800 million for all 2007. Delta, however, had $10 billion in NOL carryforwards. The company projected that these loss carryforwards would be sufficient to offset its estimated taxable income through 2010.

Source: Adapted from David Bond, "Delta Posts $155 Million Operating Profit in Runup to Exit from Chapter 11," *Aviation Daily*, April 24, 2007, News, p. 1.

then to the year immediately preceding the loss year (until it fully offsets income). If the loss is not completely used against income in the carryback period, it is carried forward for 20 years following the loss year. NOLs that are not used within the 20-year carryforward period are lost. Thus, an NOL sustained in 2010 is used first in 2008 and then 2009. Then, the loss is carried forward and offsets income in 2011 through 2030.

When an NOL is carried back, the taxpayer requests an immediate refund of prior years' taxes by filing an amended return for the previous two years. When an NOL is carried forward, the current return shows an NOL deduction for the prior year's loss. Thus, a struggling business with an NOL can receive rapid cash-flow assistance.

NOLs from Multiple Tax Years

When the taxpayer has NOLs in two or more years, the earliest year's loss is used first. Later years' losses can then be used until they are offset against income or lost. Thus, one year's return could show NOL carryovers from two or more years. Each loss is computed and applied separately.

Election to Forgo Carryback

A taxpayer can *irrevocably elect* not to carry back an NOL. The election is made on a corporate tax return (Form 1120) by checking the appropriate box. Individuals can make the election by attaching a statement to their tax return. If the election is made, the loss can *only* be carried forward for 20 years. This election may be desirable in circumstances where marginal tax rates in future years are expected to exceed rates in prior years.

6.5 The Tax Shelter Problem

LO.5

Discuss tax shelters and the reasons for at-risk and passive loss limitations.

Before Congress enacted legislation to reduce their effectiveness, **tax shelters** provided a popular way to avoid or defer taxes, as they could generate losses and other benefits to offset income from other sources. Because of the tax avoidance potential of many tax shelters, they were attractive to wealthy taxpayers with high marginal tax rates. Many tax shelters merely provided an opportunity for "investors" to buy deductions and credits in ventures that were not expected to generate a profit, even in the long run.

Although it may seem odd that a taxpayer would intentionally invest in an activity that was designed to produce losses, there is a logical explanation. The typical tax shelter operated as a partnership and relied heavily on nonrecourse financing.[22] Accelerated depreciation and interest expense deductions generated large losses in the early years of the activity. At the very least, the tax shelter deductions deferred

[22]Nonrecourse debt is an obligation for which the borrower is not personally liable. An example of nonrecourse debt is a liability on real estate acquired by a partnership without the partnership or any of the partners assuming any liability for the mortgage. The acquired property generally is pledged as collateral for the loan.

TAX in the NEWS

Limited Relief under the Stimulus Bill and Subsequent Legislation for Carrybacks

Under the American Recovery and Reinvestment Tax Act of 2009, an eligible small business can increase the carryback period for a 2008 NOL or a 2009 NOL from two years to any whole number of years that is more than two and less than six. Thus, the carryback choice is extended to three, four, or five years. An eligible small business is a taxpayer with average gross receipts of $15 million or less. The NOL involved must have occurred during a tax year beginning or ending in 2008 or 2009. See Footnote 21.

the recognition of any net income from the venture until the activity was sold. In the best of situations, the investor could realize additional tax savings by offsetting other income (e.g., salary, interest, and dividends) with losses flowing from the tax shelter. Ultimately, the sale of the investment would result in *tax-favored* capital gain. The following examples illustrate what was possible *before* Congress enacted legislation to curb tax shelter abuses.

EXAMPLE 18

Bob, who earned a salary of $400,000 as a business executive and dividend income of $15,000, invested $20,000 for a 10% interest in a cattle-breeding tax shelter. He did not participate in the operation of the business. Through the use of $800,000 of nonrecourse financing and available cash of $200,000, the partnership acquired a herd of an exotic breed of cattle costing $1 million. Depreciation, interest, and other deductions related to the activity resulted in a loss of $400,000, of which Bob's share was $40,000. Bob was allowed to deduct the $40,000 loss, even though he had invested and stood to lose only $20,000 if the investment became worthless. The net effect of the $40,000 deduction from the partnership was that a portion of Bob's salary and dividend income was "sheltered," and as a result, he was required to calculate his tax liability on only $375,000 of income [$415,000 (salary and dividends) − $40,000 (deduction)] rather than $415,000. If this deduction were available under current law and if Bob was in a combined Federal and state income tax bracket of 40%, a tax savings of $16,000 ($40,000 × 40%) would be generated in the first year alone! ■

A review of Example 18 shows that the taxpayer took a two-for-one write-off ($40,000 deduction, $20,000 investment). In the heyday of these types of tax shelters, promoters often promised even larger write-offs for the investor.

The first major provision aimed at tax shelters is the **at-risk limitation**. Its objective is to limit a taxpayer's deductions to the amount that the taxpayer could actually lose from the investment (the amount "at risk") if it becomes worthless.

EXAMPLE 19

Returning to the facts of the preceding example, under the current at-risk rules Bob would be allowed to deduct $20,000 (i.e., the amount that he could lose if the business failed). This deduction would reduce his other income, and as a result, Bob would report $395,000 of income ($415,000 − $20,000). The remaining nondeductible $20,000 loss and any future losses flowing from the partnership would be suspended under the at-risk rules and would be deductible in the future only as Bob's at-risk amount increased. ■

The second major attack on tax shelters came with the passage of the **passive loss** rules. These rules are intended to halt an investor's ability to benefit from the mismatching of an entity's expenses and income that often occurs in the early years of the business. Congress observed that despite the at-risk limitations, investors could still deduct losses flowing from an entity and thereby defer their tax liability on other income. In effect, the passive loss rules have, to a great degree, limited the tax benefits arising from such investments.



BRIDGE TO FINANCE

An overarching requirement to maximizing wealth is to reduce the present value cost of taxation. One way to reduce the cost of taxation in present value terms is to defer the payment of a tax into the future for as long as possible. This can be accomplished by reducing the taxpayer's tax base (i.e., taxable income) either by deferring the recognition of income or by accelerating the timing of deductions. As a result, to the extent that the tax cost associated with an investment alternative is reduced, the after-tax benefit from that investment and the investor's wealth position are enhanced.

For example, a common attribute of many tax-advantaged investments is the availability of tax losses that investors may claim on their own income tax returns. Many times, these tax losses are the result of investment-level deductions, such as interest and depreciation expenses, that are bunched in the early years of the life of the investment rather than being due to economic woes of the investment itself.

Through the at-risk limitations and the passive loss rules, the tax law works to scale back the ability of taxpayers to claim tax losses flowing from certain investments. These limitations have a direct impact on *when* investors can claim loss deductions flowing from affected investments. The typical result of these provisions is that the loss deductions are deferred. Therefore, when evaluating competing investment alternatives, taxpayers must address the impact of these tax limitations in projecting the after-tax benefits that can be expected to follow.

The passive loss rules require the taxpayer to segregate all income and losses into three categories: active, passive, and portfolio. In general, the passive loss limits *disallow* the deduction of passive losses *against active or portfolio income*, even when the taxpayer is at risk to the extent of the loss. In general, passive losses can only offset passive income.

EXAMPLE 20

Returning to the facts of Example 18, the passive activity loss rules further restrict Bob's ability to claim the $20,000 tax deduction shown in Example 19. Because Bob is a passive investor and does not materially participate in any meaningful way in the activities of the cattle-breeding operation, the $20,000 loss allowed under the at-risk rules is disallowed under the passive loss rules. The passive loss is disallowed because Bob does not generate any passive income that could absorb his passive loss. His salary (active income) and dividends (portfolio income) cannot be sheltered by any of the passive loss. Consequently, Bob's current-year taxable income is $415,000, and he receives no current benefit for his share of the partnership loss. However, all is not lost because Bob's share of the entity's loss is *suspended*. That is, it is carried forward and can be deducted in the future when he has passive income or sells his interest in the activity. ■

The following two sections explore the nature of the at-risk limits and the passive activity loss rules and their impact on investors. Congress intentionally structured these rules so that investors evaluating potential investments must consider mainly the *economics* of the venture instead of the *tax benefits* or tax avoidance possibilities that an investment may generate.

6.6 AT-RISK LIMITATIONS

LO.6

Describe how the at-risk limitation and the passive loss rules limit deductions for losses and identify taxpayers subject to these restrictions.

The at-risk provisions limit the deductibility of losses from business and income-producing activities. These provisions, which apply to individuals and closely held corporations, are designed to prevent taxpayers from deducting losses in excess of their actual economic investment in an activity. In the case of an S corporation or a partnership, the at-risk limits apply at the owner level. Under the at-risk rules, a taxpayer's deductible loss from an activity for any taxable year is limited to the amount

the taxpayer has at risk at the end of the taxable year (i.e., the amount the taxpayer could actually lose in the activity).

While the amount at risk generally vacillates over time, the initial amount considered at risk consists of the following:[23]

- The amount of cash and the adjusted basis of property contributed to the activity by the taxpayer.
- Amounts borrowed for use in the activity for which the taxpayer is personally liable.
- The adjusted basis of property pledged as security that is not used in the activity.

This amount generally is increased each year by the taxpayer's share of income and is decreased by the taxpayer's share of losses and withdrawals from the activity. In addition, because *general partners* are jointly and severally liable for recourse debts of the partnership, their at-risk amounts are increased when the partnership increases its debt and are decreased when the partnership reduces its debt. However, a taxpayer generally is not considered at risk with respect to borrowed amounts if either of the following is true:

- The taxpayer is not personally liable for repayment of the debt (e.g., nonrecourse debt).
- The lender has an interest (other than as a creditor) in the activity.

An important exception provides that, in the case of an activity involving the holding of real property, a taxpayer is considered at risk for his or her share of any *qualified nonrecourse financing* that is secured by real property used in the activity.[24]

Subject to the passive activity rules discussed later in the chapter, a taxpayer may deduct a loss as long as the at-risk amount is positive. However, once the at-risk amount is exhausted, any remaining loss cannot be deducted until a later year. Any losses disallowed for any given taxable year by the at-risk rules may be deducted in the first succeeding year in which the rules do not prevent the deduction—that is, when there is, and to the extent of, a positive at-risk amount.

EXAMPLE 21

In 2010, Sue invests $40,000 in an oil partnership. The partnership, through the use of nonrecourse loans, spends $60,000 on deductible intangible drilling costs applicable to Sue's interest. Assume Sue's interest in the partnership is subject to the at-risk limits but is not subject to the passive loss limits. Since Sue has only $40,000 of capital at risk, she cannot deduct more than $40,000 against her other income and must reduce her at-risk amount to zero ($40,000 at-risk amount − $40,000 loss deducted). The nondeductible loss of $20,000 ($60,000 loss generated − $40,000 loss allowed) can be carried over to 2011.

In 2011, Sue has taxable income of $15,000 from the oil partnership and invests an additional $10,000 in the venture. Her at-risk amount is now $25,000 ($0 beginning balance + $15,000 taxable income + $10,000 additional investment). This enables Sue to deduct the $20,000 carryover loss and requires her to reduce her at-risk amount to $5,000 ($25,000 at-risk amount − $20,000 carryover loss allowed). ■

An additional complicating factor is that previously allowed losses must be recaptured as income to the extent the at-risk amount is reduced below zero.[25] This rule applies in situations such as when the amount at risk is reduced below zero by distributions to the taxpayer or when the status of indebtedness changes from recourse to nonrecourse.

[23] § 465(b)(1).

[24] Section 465(b)(6) defines qualified nonrecourse financing.

[25] § 465(e).



CONCEPT SUMMARY 6.3

Calculation of At-Risk Amount

Increases to a taxpayer's at-risk amount:

- Cash and the adjusted basis of property contributed to the activity.
- Amounts borrowed for use in the activity for which the taxpayer is personally liable.
- The adjusted basis of property pledged as security that is not used in the activity.
- Taxpayer's share of amounts borrowed for use in the activity that are qualified nonrecourse financing.
- Taxpayer's share of the activity's income.

Decreases to a taxpayer's at-risk amount:

- Withdrawals from the activity.
- Taxpayer's share of the activity's deductible loss.
- Taxpayer's share of any reductions of debt for which recourse against the taxpayer exists or reductions of qualified nonrecourse debt.

6.7 Passive Loss Limits

CLASSIFICATION AND IMPACT OF PASSIVE INCOME AND LOSS

The passive loss rules operate by requiring taxpayers to classify their income and losses into various categories. Then the rules limit the extent to which losses in the passive category can be used to offset income in the other categories.

Classification

The passive loss rules require income and loss to be classified into one of three categories: *active, passive,* or *portfolio.* **Active income** includes the following:

- Wages, salary, commissions, bonuses, and other payments for services rendered by the taxpayer.
- Profit from a trade or business in which the taxpayer is a material participant.

Portfolio income includes the following:

- Interest, dividends, annuities, and royalties not derived in the ordinary course of a trade or business.
- Gain or loss from the disposition of property that produces portfolio income or is held for investment purposes.

Section 469 provides that income or loss from the following activities is treated as *passive:*

- Any trade or business or income-producing activity in which the taxpayer does not materially participate.
- Subject to certain exceptions, all rental activities, whether the taxpayer materially participates or not.

Although the Code defines rental activities as passive activities, several exceptions allow losses from certain real estate rental activities to offset nonpassive (active or portfolio) income. These exceptions are discussed under Special Rules for Real Estate later in the chapter.

General Impact

Losses or expenses generated by passive activities can only be deducted to the extent of income from passive activities. Any excess may not be used to offset income from

active or portfolio income. Instead, any unused passive losses are suspended and carried forward to future years to offset passive income generated in those years. Otherwise, suspended losses may be used only when a taxpayer disposes of his or her entire interest in an activity. In that event, all current and suspended losses related to the activity may offset active and portfolio income.

Kim, a physician, earns $150,000 from her full-time practice. She also receives $10,000 in dividends and interest from various portfolio investments, and her share of loss from a passive investment not limited by the at-risk rules is $60,000. Because the loss is a passive loss, it is not deductible against her other income. The loss is suspended and is carried over to the future. If Kim has passive income from this investment or from other passive investments in the future, she can offset the suspended loss against that passive income. If she does not have passive income to offset this suspended loss in the future, she will be allowed to offset the loss against other types of income when she eventually disposes of the passive activity. ■

Impact of Suspended Losses

The actual economic gain or loss from a passive investment (including any suspended losses) can be determined when a taxpayer disposes of his or her entire interest in the investment. As a result, under the passive loss rules, upon a fully taxable disposition, any overall loss realized from the activity by the taxpayer is recognized and can be offset against passive, active, and portfolio income.

A fully taxable disposition generally involves a sale of the property to a third party at arm's length and thus, presumably, for a price equal to the property's fair market value. Gain recognized upon a transfer of an interest in a passive activity generally is treated as passive and is first offset by the suspended losses from that activity.

Rex sells an apartment building, a passive activity, with an adjusted basis of $100,000 for $180,000. In addition, he has suspended passive losses of $60,000 associated with the building. His total gain, $80,000, and his taxable gain, $20,000, are calculated as follows:

Net sales price	$ 180,000
Less: Adjusted basis	(100,000)
Total gain	$ 80,000
Less: Suspended losses	(60,000)
Taxable gain (passive)	$ 20,000

■

If current and suspended losses of the passive activity exceed the gain realized from the sale or if the sale results in a realized loss, the amount of

- any loss from the activity for the tax year (including losses suspended in the activity disposed of)

in excess of

- net income or gain for the tax year from all passive activities (without regard to the activity disposed of)

is treated as a loss that is not from a passive activity. In computing the loss from the activity for the year of disposition, any gain or loss recognized is included in the calculation.

Dean sells an apartment building, a passive activity, with an adjusted basis of $100,000 for $150,000. In addition, he has current and suspended passive losses of $60,000

associated with the building and has no other passive activities. His total gain of $50,000 and his deductible loss of $10,000 are calculated as follows:

Net sales price	$ 150,000
Less: Adjusted basis	(100,000)
Total gain	$ 50,000
Less: Suspended losses	(60,000)
Deductible loss (not passive)	($ 10,000)

The $10,000 loss can be deducted against Dean's active and portfolio income. ■

Carryovers of Suspended Losses

In the above examples, it was assumed that the taxpayer had an interest in only one passive activity, and as a result, the suspended loss was related exclusively to the activity that was disposed of. When a taxpayer owns more than one passive activity, however, any suspended losses must be allocated among the activities. The allocation to an activity is made by multiplying the disallowed passive activity loss from all activities by the following fraction:

$$\frac{\text{Loss from activity}}{\text{Sum of losses for taxable year from all activities having losses}}$$

EXAMPLE 25

Diego has investments in three passive activities with the following income and losses for 2009:

Activity A	($ 30,000)
Activity B	(20,000)
Activity C	25,000
Net passive loss	($ 25,000)
Net passive loss allocated to:	
Activity A [$25,000 × ($30,000/$50,000)]	($ 15,000)
Activity B [$25,000 × ($20,000/$50,000)]	(10,000)
Total suspended losses	($ 25,000)

■

Suspended losses are carried over indefinitely and are offset in the future against any passive income from the activities to which they relate.[26]

EXAMPLE 26

Assume the same facts as in the preceding example and that Activity A produces $10,000 of income in 2010. Of the suspended loss of $15,000 from 2009 for Activity A, $10,000 is offset against the income from this activity. If Diego sells Activity A in early 2011, then the remaining $5,000 suspended loss is used in determining his final gain or loss. ■

Passive Credits

Credits arising from passive activities are limited in much the same way as passive losses. Passive credits can be utilized only against regular tax attributable to passive income,[27] which is calculated by comparing the tax on all income (including passive income) with the tax on income excluding passive income.

EXAMPLE 27

Sam owes $50,000 of tax, disregarding net passive income, and $80,000 of tax, considering both net passive and other taxable income (disregarding the credits in both cases). The amount of tax attributable to the passive income is $30,000. ■

Sam in the preceding example can claim a maximum of $30,000 of passive activity credits; the excess credits are carried over. These passive activity credits (such as the

[26] § 469(b). [27] § 469(d)(2).

rehabilitation credit—discussed in Chapter 14) can be used only against the *regular* tax attributable to passive income. If a taxpayer has a net loss from passive activities during a given year, no credits can be used.

Carryovers of Passive Credits

Tax credits attributable to passive activities can be carried forward indefinitely, much like suspended passive losses. Unlike passive losses, however, passive credits are lost forever when the activity is disposed of in a taxable transaction where loss is recognized. Credits are allowed on dispositions only when there is sufficient tax on passive income to absorb them.

EXAMPLE 31

Alicia sells a passive activity for a gain of $10,000. The activity had suspended losses of $40,000 and suspended credits of $15,000. The $10,000 gain is offset by $10,000 of the suspended losses, and the remaining $30,000 of suspended losses is deductible against Alicia's active and portfolio income. The suspended credits are lost forever because the sale of the activity did not generate any tax after considering the effect of the suspended losses. ■

EXAMPLE 32

If Alicia in the preceding example had realized a $100,000 gain on the sale of the passive activity, the suspended credits could have been used to the extent of the regular tax attributable to the net passive income.

Gain on sale	$100,000
Less: Suspended losses	(40,000)
Net gain	$ 60,000

If the tax attributable to the net gain of $60,000 is $15,000 or more, the entire $15,000 of suspended credits can be used. If the tax attributable to the gain is less than $15,000, the excess of the suspended credits over the tax attributable to the gain is lost forever. ■

When a taxpayer has sufficient regular tax liability from passive activities to trigger the use of suspended credits, the credits lose their character as passive credits. They are reclassified as regular tax credits and made subject to the same limits as other credits (see Chapter 14).

Passive Activity Changes to Active

If a formerly passive activity becomes active, suspended losses are allowed to the extent of income from the now active business.[28] If any of the suspended loss remains, it continues to be treated as a loss from a passive activity. The excess suspended loss can be deducted against passive income or carried over to the next tax year and deducted to the extent of income from the now active business in the succeeding year(s).

TAXPAYERS SUBJECT TO THE PASSIVE LOSS RULES

The passive loss rules apply to individuals, estates, trusts, personal service corporations, and closely held C corporations.[29] Passive income or loss from investments in partnerships or S corporations (see Chapters 11 and 12) flows through to the owners, and the passive loss rules are applied at the owner level. Consequently, it is necessary to understand how the passive activity rules apply to both entities *and* their owners (including individual taxpayers).

[28] § 469(f).

[29] § 469(a).

TAX in the NEWS

Tax Shelters Have Been Knocked Down, but Not Out!

Over the years, the at-risk and passive loss rules have gone a long way toward curbing abusive tax shelters. To the IRS's chagrin, however, some tax shelters not restricted by these rules have compelled the IRS to invest thousands of hours battling various tax schemes it considers abusive. Its actions, supported by court decisions, have largely succeeded in snuffing out many of the most abusive shelters. The IRS has been particularly effective in curbing a type of shelter known as "Son of Boss." As a result, many large accounting and law firms are no longer in the business of developing and marketing these more questionable strategies.

But just because some taxpayers have been a bit too creative in using the tax law for financial advantage does not mean that all tax shelters are illegal or somehow immoral. Many "tax minimization strategies," such as arranging well-timed property transactions that postpone taxes or sheltering assets in a § 401(k) retirement account, are well within the bounds of appropriate tax planning. These types of tax shelters involve transactions and wealth generation strategies that all taxpayers should consider.

Personal Service Corporations

Application of the passive loss limitations to personal service corporations is intended to prevent taxpayers from sheltering personal service income by creating personal service corporations and acquiring passive activities at the corporate level.

EXAMPLE 30

Two tax accountants, who earn an aggregate of $200,000 a year in their individual practices, agree to work together in a newly formed personal service corporation. Shortly after its formation, the corporation invests in a passive activity that produces a $200,000 loss during the year. Because the passive loss rules apply to personal service corporations, the corporation may not deduct the $200,000 passive loss against the $200,000 of active income. ■

Determination of whether a corporation is a **personal service corporation** is based on rather broad definitions. A personal service corporation is a regular (or C) corporation that meets both of the following conditions:

- The principal activity is the performance of personal services.
- Such services are substantially performed by owner-employees.

Generally, personal service corporations include those in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, and consulting.[30]

DIGGING DEEPER 3

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

Closely Held C Corporations

Application of the passive loss rules to closely held (non-personal service) C corporations is also intended to prevent individuals from incorporating to avoid the passive loss limitations. A corporation is classified as a **closely held C corporation** if at any time during the taxable year, more than 50 percent of the value of its outstanding stock is owned, directly or indirectly, by or for five or fewer individuals. Closely held C corporations (other than personal service corporations) may use passive losses to offset *active* income, but *not portfolio* income.

[30] § 448(d)(2)(A).

EXAMPLE 31

Silver Corporation, a closely held (non-personal service) C corporation, has a $500,000 passive loss from a rental activity, $400,000 of active income, and $100,000 of portfolio income. The corporation may offset $400,000 of the $500,000 passive loss against the $400,000 of active business income, but may not offset the remainder against the $100,000 of portfolio income. Thus, $100,000 of the passive loss is suspended ($500,000 passive loss − $400,000 offset against active income). ■

Application of the passive loss limitations to closely held C corporations prevents shareholders from transferring their portfolio investments to such corporations in order to offset passive losses against portfolio income.

ACTIVITY DEFINED

LO.7

Discuss and be able to apply the definitions of activity, material participation, and rental activity under the passive loss rules.

Identifying what constitutes an activity is a necessary first step in applying the passive loss limitation. The rules used to delineate an activity state that, in general, a taxpayer can treat one or more trade or business activities or rental activities as a single activity if those activities form an *appropriate economic unit* for measuring gain or loss. The Regulations provide guidelines for identifying appropriate economic units.[31] These guidelines are designed to prevent taxpayers from arbitrarily combining different businesses in an attempt to circumvent the passive loss limitation. For example, combining a profitable active business and a passive business generating losses into one activity would allow the taxpayer to offset passive losses against active income.

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.



To determine which ventures form an appropriate economic unit, all of the relevant facts and circumstances must be considered. However, special rules restrict the grouping of rental and nonrental activities.[32] The example below, adapted from the Regulations, illustrates the application of the activity grouping rules.[33]

EXAMPLE 32

George owns a men's clothing store and an Internet café in Chicago. He also owns a men's clothing store and an Internet café in Milwaukee. Reasonable methods of applying the facts and circumstances test may result in any of the following groupings:

- All four businesses may be grouped into a single activity because of common ownership and control.
- The clothing stores may be grouped into an activity, and the Internet cafés may be grouped into an activity.
- The Chicago businesses may be grouped into an activity, and the Milwaukee businesses may be grouped into an activity.
- Each of the four businesses may be treated as a separate activity. ■

Once a set of activities has been grouped by the taxpayer using the above rules, the grouping cannot be changed unless a material change in the facts and circumstances occurs or the original grouping was clearly inappropriate. In addition, the Regulations also grant the IRS the right to regroup activities when one of the primary purposes of the taxpayer's grouping is to avoid the passive loss limitation and the grouping fails to reflect an appropriate economic unit.[34]

[31]Reg. § 1.469–4.
[32]Reg. § 1.469–4(d).
[33]Reg. § 1.469–4(c)(3).
[34]Reg. § 1.469–4(f).

MATERIAL PARTICIPATION

If a taxpayer materially participates in a nonrental trade or business activity, any loss from that activity is treated as an active loss that can offset active or portfolio income. If a taxpayer does not materially participate, however, the loss is treated as a passive loss, which can only offset passive income. Therefore, controlling whether a particular activity is treated as active or passive is an important part of the tax strategy of a taxpayer who owns an interest in one or more businesses. Consider the following examples.

EXAMPLE 33

Cameron, a corporate executive, earns a salary of $600,000 per year. In addition, he owns a separate business in which he participates. The business produces a loss of $100,000 during the year. If Cameron materially participates in the business, the $100,000 loss is an active loss that may offset his active income from his corporate employer. If he does not materially participate, the loss is passive and is suspended. Cameron may use the suspended loss in the future only when he has passive income or disposes of the activity. ■

EXAMPLE 34

Connor, an attorney, earns $350,000 a year in his law practice. He owns interests in two activities, A and B, in which he participates. Activity A, in which he does not *materially* participate, produces a loss of $50,000. Connor has not yet met the material participation standard for Activity B, which produces income of $80,000. However, he can meet the material participation standard if he spends an additional 50 hours in Activity B during the year. Should Connor attempt to meet the material participation standard for Activity B? If he continues working in Activity B and becomes a material participant, the $80,000 of income from the activity is active, and the $50,000 passive loss from Activity A must be suspended. A more favorable tax strategy is for Connor to *not meet* the material participation standard for Activity B, thus making the income from that activity passive. This enables him to offset the $50,000 passive loss from Activity A against the passive income from Activity B. ■

It is possible to devise numerous scenarios in which the taxpayer could control the tax outcome by increasing or decreasing participation in different activities. Examples 33 and 34 demonstrate two of the possibilities. The conclusion reached in most analyses of this type is that taxpayers will benefit by having profitable activities classified as passive so that any passive losses can be used to offset that passive income. If the activity produces a loss, however, the taxpayer will benefit if it is classified as active so that the loss is not subject to the passive loss limitations.

Temporary Regulations[35] provide seven tests that are intended to help taxpayers determine when **material participation** is achieved.

Tests Based on Current Participation

The first four tests are quantitative tests that require measurement, in hours, of the individual's participation in the activity during the year.

1. *Does the individual participate in the activity for more than 500 hours during the year?*

The purpose of the 500-hour requirement is to restrict deductions from the types of trade or business activities that Congress intended to treat as passive activities. The 500-hour standard for material participation was adopted for the following reasons:[36]

- Few investors in traditional tax shelters devote more than 500 hours a year to such an investment.
- The IRS believes that income from an activity in which the taxpayer participates for more than 500 hours a year should not be treated as passive.

[35]Temp.Reg. § 1.469–5T(a).

[36]T.D. 8175, 1988–1 C.B. 191.

2. *Does the individual's participation in the activity for the taxable year constitute substantially all of the participation in the activity of all individuals (including nonowner employees) for the year?*

Ned, a physician, operates a separate business in which he participates for 80 hours during the year. He is the only participant and has no employees in the separate business. Ned meets the material participation standard of Test 2. If he had employees, it could be difficult to apply Test 2, because the Temporary Regulations do not define the term "substantially all." ■

3. *Does the individual participate in the activity for more than 100 hours during the year, and is the individual's participation in the activity for the year not less than the participation of any other individual (including nonowner employees) for the year?*

Adam, a college professor, owns a separate business in which he participates 110 hours during the year. He has an employee who works 90 hours during the year. Adam meets the material participation standard under Test 3, but probably does not meet it under Test 2 because his participation is only 55% of the total participation. It is unlikely that 55% would meet the substantially all requirement of Test 2. ■

Tests 2 and 3 are included because the IRS recognizes that the operation of some activities does not require more than 500 hours of participation during the year.

4. *Is the activity a significant participation activity for the taxable year, and does the individual's aggregate participation in all significant participation activities during the year exceed 500 hours?*

A **significant participation activity** is a trade or business in which the individual's participation exceeds 100 hours during the year. This test treats taxpayers as material participants if their aggregate participation in several significant participation activities exceeds 500 hours. Test 4 thus accords the same treatment to an individual who devotes an aggregate of more than 500 hours to several significant participation activities as to an individual who devotes more than 500 hours to a single activity.

Mike owns five different businesses. He participates in each activity during the year as follows:

Activity	Hours of Participation
A	110
B	140
C	120
D	150
E	100

Activities A, B, C, and D are significant participation activities, and Mike's aggregate participation in those activities is 520 hours. Therefore, Activities A, B, C, and D are *not* treated as passive activities. Activity E is not a significant participation activity (not more than 100 hours), so it is not included in applying the 500-hour test. Activity E is treated as a passive activity, unless Mike meets one of the other material participation tests for that activity. ■

Assume the same facts as in the preceding example, except that Activity A does not exist. All of the activities are now treated as passive under Test 4. Activity E is not counted in applying the more-than-500-hour test, so Mike's aggregate participation in

significant participation activities is 410 hours (140 in Activity B + 120 in Activity C + 150 in Activity D). He could meet the significant participation test for Activity E by participating for one more hour in the activity. This would cause Activities B, C, D, and E to be treated as nonpassive activities. However, before deciding whether to participate for at least one more hour in Activity E, Mike should assess how the participation would affect his overall tax liability. ■

Tests Based on Prior Participation

Tests 5 and 6 are based on material participation in prior years. Under these tests, a taxpayer no longer participating in an activity can continue to be *classified* as a material participant. The IRS takes the position that material participation in a trade or business for a long period of time is likely to indicate that the activity represents the individual's principal livelihood, rather than a passive investment. Consequently, withdrawal from the activity or reduction of participation to the point where it is not material does not change the classification of the activity from active to passive.

5. *Did the individual materially participate in the activity for any five taxable years (whether consecutive or not) during the 10 taxable years that immediately precede the taxable year?*

EXAMPLE 9

Dawn, who owns a 50% interest in a restaurant, was a material participant in the operations of the restaurant from 2004 through 2008. She retired at the end of 2008 and is no longer involved in the restaurant except as an investor. Dawn will be treated as a material participant in the restaurant in 2009. Even if she does not become involved in the restaurant as a material participant again, she will continue to be treated as a material participant in 2010, 2011, 2012, and 2013. In 2014 and later years, Dawn's share of income or loss from the restaurant will be classified as passive unless she materially participates in those years. ■

6. *Is the activity a personal service activity, and did the individual materially participate in the activity for any three preceding taxable years (whether consecutive or not)?*

As indicated above, the material participation standards for personal service activities differ from other businesses. An individual who was a material participant in a personal service activity for *any three years* prior to the taxable year continues to be treated as a material participant after withdrawal from the activity.

EXAMPLE 10

Evan, a CPA, retires from the EFG Partnership after working full-time in the partnership for 30 years. As a retired partner, he will continue to receive a share of the profits of the firm for the next 10 years, even though he will not participate in the firm's operations. Evan also owns an interest in a passive activity that produces a loss for the year. Because he continues to be treated as a material participant in the EFG Partnership, his income from the partnership is active income. Therefore, he is not allowed to offset the loss from his passive investment against the income from the EFG Partnership. ■

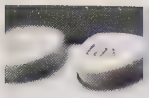
Test Based on Facts and Circumstances

Test 7 assesses the facts and circumstances to determine whether the taxpayer has materially participated.

7. *Based on all the facts and circumstances, did the individual participate in the activity on a regular, continuous, and substantial basis during the year?*



In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.



CONCEPT SUMMARY 6.4

Passive Activity Loss Rules: General Concepts

What is the fundamental passive activity rule?	Passive activity losses may be deducted only against passive activity income and gains. Losses not allowed are suspended and used in future years.
Who is subject to the passive activity rules?	Individuals. Estates. Trusts. Personal service corporations. Closely held C corporations.
What is a passive activity?	Trade or business or income-producing activity in which the taxpayer does not materially participate during the year, or rental activities, subject to certain exceptions, regardless of the taxpayer's level of participation.
What is an activity?	One or more trades or businesses or rental activities that comprise an appropriate economic unit.
How is an appropriate economic unit determined?	Based on a reasonable application of the relevant facts and circumstances.
What is material participation?	In general, the taxpayer participates on a regular, continuous, and substantial basis. More specifically, when the taxpayer meets the conditions of one of the seven tests provided in the Regulations.
What is a rental activity?	In general, an activity where payments are received for the use of tangible property. More specifically, a rental activity that does *not* meet one of the six exceptions provided in the Regulations. Special rules apply to rental real estate.

Unfortunately, the Temporary Regulations do not define what constitutes regular, continuous, and substantial participation.[37]

Participation Defined

Participation generally includes any work done by an individual in an activity that he or she owns. Participation does not include work if it is of a type not customarily done by owners *and* if one of its principal purposes is to avoid the disallowance of passive losses or credits. Also, work done in an individual's capacity as an investor (e.g., reviewing financial reports in a nonmanagerial capacity) is not counted in applying the material participation tests. However, participation by an owner's spouse counts as participation by the owner.[38]

Tom, who is a partner in a CPA firm, owns a computer store that has operated at a loss during the year. In order to offset this loss against the income from his CPA practice, Tom would like to avoid having the computer business classified as a passive activity. Through December 15, he has worked 400 hours in the business in management and selling activities. During the last two weeks of December, he works 80 hours in management and selling activities and 30 hours doing janitorial chores. Also during the last two weeks in December, Tom's wife participates 40 hours as a salesperson. She has worked as a salesperson in the computer store in prior years, but has not done so during the current year. If any of Tom's work is of a type not customarily done by owners and if one of its principal purposes is to avoid the disallowance of passive losses or credits, it is not counted in applying the material participation tests. It is likely that Tom's 480 hours of participation in management and selling activities will count as

[37]Temp.Reg. § 1.469–5T(b)(2).

[38]Temp.Reg. § 1.469–5T(f)(3).

TAXin the NEWS

Are Nebraska Farmers Similar to Owners of Other LLCs and LLPs?

A major advantage for limited partners in a limited partnership is that their personal exposure to potential business losses is restricted to their investments in the partnership. Further, from an operational perspective, a typical limited partner is truly a passive investor since he or she does not participate in the business or its management. As a result, the Temporary Regulations presume that a limited partner is not a material participant unless the individual qualifies under Test 1, 5, or 6.

As limited liability companies (LLCs) and limited liability partnerships (LLPs) have grown in popularity in the United States, however, the question has arisen as to whether owners of interests in these business forms who *are* active in the businesses should be presumed to not be material participants under the usual rules applicable to limited partners. In a recent Tax Court decision [*Paul D. Garnett*, 132 T.C. __, No. 19 (2009)], Nebraska chicken and pig farmers who operated their businesses as LLCs and LLPs and played active roles were considered more akin to general partners. The court held that their material participation status should be determined by an analysis of the particular facts and circumstances of the situation and the material participation rules in general. The implication of this decision is that many taxpayers who are participants in LLCs or LLPs may be in a position to avoid the passive loss rules altogether merely by applying the general material participation tests found in the Temporary Regulations. As the IRS has historically resisted this approach, the resolution of the issue remains unclear.

participation, but the 30 hours spent doing janitorial chores will not. However, the 40 hours of participation by his wife will count, and as a result, Tom will qualify as a material participant under the more-than-500-hour rule (480 + 40 = 520). ■

Limited Partners

A *limited* partner is one whose liability to third-party creditors of the partnership is limited to the amount the partner has invested in the partnership. Such a partnership must have at least one *general* partner, who is fully liable in an individual capacity for the debts of the partnership to third parties. Generally, a *limited partner* is not considered a material participant unless he or she qualifies under Test 1, 5, or 6 in the above list. However, a *general partner* may qualify as a material participant by meeting any of the seven tests. If a general partner also owns a limited interest in the same limited partnership, all interests are treated as a general interest.[39]

Corporations

Personal service corporations and closely held C corporations cannot directly participate in an activity. However, a corporation is deemed to materially participate if its owners materially participate in an activity of the corporation. Together, the participating owners must own directly or indirectly more than 50 percent of the value of the outstanding stock of the corporation.[40] Alternatively, a closely held C corporation may be deemed to materially participate in an activity if, during the entire year, it has at least one full-time employee actively managing the business and at least three full-time nonowner employees working for the business. In addition, the corporation's trade or business expenses must exceed the gross income from that business by 15 percent for the year.[41]

RENTAL ACTIVITIES

Subject to certain exceptions, all rental activities are to be treated as passive activities.[42] A **rental activity** is defined as any activity where payments are received principally for the use of tangible (real or personal) property.[43] Importantly, an activity that is classified as a rental activity is subject to the passive activity loss rules, even if the taxpayer involved is a material participant.

[39] § 469(h)(2) and Temp.Reg. § 1.469–5T(e)(3)(ii).
[40] Temp.Reg. § 1.469–1T(g)(3)(i)(A).
[41] Temp.Reg. § 1.469–1T(g)(3)(i)(B).
[42] § 469(c)(2).
[43] § 469(j)(8).

Sarah owns a fleet of automobiles that are held for rent and spends an average of 60 hours a week in the activity. Assuming that her automobile business is classified as a rental activity, it is automatically subject to the passive activity rules, even though Sarah spends more than 500 hours a year in its operation. ■

Temporary Regulations, however, provide exceptions for certain situations where activities involving rentals of real and personal property are *not* to be treated as rental activities.[44] Activities covered by any of the exceptions provided by the Temporary Regulations are not *automatically* treated as passive activities because they would not be classified as rental activities. Instead, the activities are subject to the material participation tests.

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.



Dan owns a DVD rental business. Because the average period of customer use is seven days or less, Dan's business is not treated as a rental activity. ■

The fact that Dan's DVD business in the previous example is not treated as a rental activity does not necessarily mean that it is classified as a nonpassive activity. Instead, the DVD business is treated as a trade or business activity subject to the material participation standards. If Dan is a material participant, the business is treated as active. If he is not a material participant, it is treated as a passive activity.

INTERACTION OF AT-RISK AND PASSIVE ACTIVITY LIMITS

LO.8

Recognize the relationship between the at-risk and passive activity limitations.

The determination of whether a loss is suspended under the passive loss rules is made *after* application of the at-risk rules, as well as other provisions relating to the measurement of taxable income. A loss that is not allowed for the year because the taxpayer is not at risk with respect to it is suspended under the at-risk provision and not under the passive loss rules. Further, a taxpayer's basis is reduced by deductions (e.g., depreciation) even if the deductions are not currently usable because of the passive loss rules.

Jack's adjusted basis in a passive activity is $10,000 at the beginning of 2009. His loss from the activity in 2009 is $4,000. Since Jack has no passive activity income, the $4,000 cannot be deducted. At year-end, Jack has an adjusted basis and an at-risk amount of $6,000 in the activity and a suspended passive loss of $4,000. ■

Jack in the preceding example has a loss of $9,000 in the activity in 2010. Since the $9,000 exceeds his at-risk amount ($6,000) by $3,000, that $3,000 loss is disallowed by the at-risk rules. If Jack has no passive activity income, the remaining $6,000 is suspended under the passive activity rules. At year-end, he has:

- A $3,000 loss suspended under the at-risk rules.
- $10,000 of suspended passive losses.
- An adjusted basis and at-risk amount in the activity of zero. ■

Jack in Example 45 realizes $1,000 of passive income from the activity in 2011. Because the $1,000 increases his at-risk amount, $1,000 of the $3,000 unused loss is reclassified as a passive loss. If he has no other passive income, the $1,000 income is offset by $1,000 of suspended passive losses. At the end of 2011, Jack has:

[44]Temp.Reg. § 1.469–1T(e)(3)(ii).

Noncompliance Costs with Rental Real Estate

The IRS has estimated that approximately $13 billion of the tax gap is due to unreported taxes related to rental real estate activities. This may be due, at least in part, to the challenges taxpayers face in attempting to comply with the passive activity loss rules. The Government Accountability Office concluded in a recent study that substantial additional tax revenues could be generated with even small improvements in compliance. Their study shows the following most common types of rental real estate misreporting.

Estimated Frequency of Types of Individual Taxpayer Misreporting of Rental Real Estate Activities

Type of Misreporting	Estimated Percentage of Taxpayers with Rental Real Estate Activity Who Misreported
Misreported rental real estate expenses	43
Misreported rent received	15
Reported activity on an incorrect part of the individual tax return	6
Misreported loss from rental real estate	2
Other types of misreporting	5
All types of misreporting	53

Source: "Tax Gap: Actions That Could Improve Rental Real Estate Reporting Compliance," Report to the Committee on Finance, U.S. Senate, United States Government Accountability Office, August 2008.

- No taxable passive income.
- $2,000 ($3,000 – $1,000) of unused losses under the at-risk rules.
- $10,000 of (reclassified) suspended passive losses ($10,000 + $1,000 of reclassified unused at-risk losses – $1,000 of passive losses offset against passive income).
- An adjusted basis and an at-risk amount in the activity of zero. ■

EXAMPLE 47

In 2012, Jack has no gain or loss from the activity in Example 46. He contributes $5,000 more to the passive activity. Because the $5,000 contribution increases his at-risk amount, the $2,000 of losses suspended under the at-risk rules is reclassified as passive. Jack gets no passive loss deduction in 2012. At year-end, he has:

- No suspended losses under the at-risk rules.
- $12,000 of suspended passive losses ($10,000 + $2,000 of reclassified suspended at-risk losses).
- An adjusted basis and an at-risk amount of $3,000 ($5,000 additional investment – $2,000 of reclassified losses). ■

LO.9

Discuss the special treatment available to real estate activities.

SPECIAL RULES FOR REAL ESTATE

The passive loss rules contain two exceptions related to real estate activities. These exceptions allow all or part of real estate rental losses to offset active or portfolio income, even though the activity otherwise is defined as a passive activity.

Real Estate Professionals

The first exception allows certain real estate professionals to avoid passive loss treatment for losses from real estate rental activities.[45] To qualify for nonpassive treatment, a taxpayer must satisfy both of the following requirements:

[45] § 469(c)(7).

TAX in the NEWS

Record Keeping Involves Creative Writing for Some!

One exception to the passive loss rules allows real estate professionals to treat rental losses as active if they arise from a business that is an active endeavor as opposed to one that is more passive oriented. To receive this preferential treatment, however, Temp.Reg. § 1.469–5T(f)(4) requires a real estate professional to show "by any reasonable means" that more than half of his or her personal services rendered during a year were devoted to real estate trades or businesses. Although contemporaneous records may be the best way to accumulate the necessary proof of involvement, many taxpayers wait to build their case "after the fact." This approach can result in the taxpayers providing nothing more than "ballpark guesstimates!"

The Lee brothers, one a doctor and professor and the other a full-time IRS employee, apparently found themselves in just such a predicament (*Kai H. and Susanna Lee; Ulysses K. and Jane Lee,* 92 TCM 263, T.C.Memo. 2006–193). After they deducted significant rental losses on their returns as real estate professionals, the IRS asked for documentation of their hours. Not only did the claims that the Lees presented in court more than double the time of the first logs submitted to the IRS, but some of their log entries strained credibility. For example, one brother claimed that he spent "24 hours to replace four miniblinds in one of the apartments, 42 hours to paint another, and 56 hours to install a new toilet in a third." Such seemingly inflated hours devoted to their real estate ventures were accompanied by unrealistically low assessments of the hours spent at their full-time jobs. Needless to say, the court concluded that the logs were not credible and, therefore, the Lees were not real estate professionals.

- More than half of the personal services that the taxpayer performs in trades or businesses are performed in real property trades or businesses in which the taxpayer materially participates.
- The taxpayer performs more than 750 hours of services in these real property trades or businesses as a material participant.

Taxpayers who do not satisfy the above requirements must continue to treat losses from real estate rental activities as passive losses.

During the current year, Della performs personal service activities as follows: 900 hours as a personal financial planner, 550 hours in a real estate development business, and 600 hours in a real estate rental activity. Any loss Della incurs in either real estate activity will not be subject to the passive loss rules. Being a nonrental business, the real estate development business is deemed active under the more-than-500-hour rule. The real estate rental activity is active since more than 50% of her personal services are devoted to real property trades or businesses (i.e., the development and rental businesses), and her material participation in those real estate activities exceeds 750 hours. Thus, any losses from either real estate activity can offset active and portfolio income. ■

As discussed earlier, a spouse's work is taken into consideration in satisfying the material participation requirement. However, the hours worked by a spouse are not taken into account when ascertaining whether a taxpayer has worked for more than 750 hours in real property trades or businesses during a year. Services performed by an employee are not treated as being related to a real estate trade or business unless the employee performing the services owns more than a 5 percent interest in the employer. Additionally, a closely held C corporation may also qualify for the passive loss relief if more than 50 percent of its gross receipts for the year are derived from real property trades or businesses in which it materially participates.[46]

[46] § 469(c)(7)(B) and Reg. § 1.469–9.

Rental Real Estate Deduction

The second exception is more significant in that it is not restricted to real estate professionals. This exception allows individuals to deduct up to $25,000 of losses from real estate rental activities against active and portfolio income.[47] The potential annual $25,000 deduction is reduced by 50 percent of the taxpayer's adjusted gross income (AGI) in excess of $100,000. Thus, the entire deduction is phased out at $150,000. If married individuals file separately, the $25,000 deduction is reduced to zero unless they lived apart for the entire year. If they lived apart for the entire year, the loss amount is $12,500 each, and the phaseout begins at $50,000.

To qualify for the $25,000 exception, a taxpayer must:[48]

- *Actively participate* in the real estate rental activity.
- Own 10 percent or more (in value) of all interests in the activity during the entire taxable year (or shorter period during which the taxpayer held an interest in the activity).

The difference between *active participation* and *material participation* is that the former can be satisfied without regular, continuous, and substantial involvement in operations as long as the taxpayer participates in making management decisions in a significant and bona fide sense. In this context, relevant management decisions include such decisions as approving new tenants, deciding on rental terms, and approving capital or repair expenditures.

The $25,000 allowance is available after all active participation rental losses and gains are netted and applied to other passive income. If a taxpayer has a real estate rental loss in excess of the amount that can be deducted under the real estate rental exception, that excess is treated as a passive loss.

EXAMPLE 40

Brad, who has $90,000 of AGI before considering rental activities, has $85,000 of losses from a real estate rental activity in which he actively participates. He also actively participates in another real estate rental activity from which he has $25,000 of income. He has other passive income of $36,000. Of the net rental loss of $60,000, $36,000 is absorbed by the passive income, leaving $24,000 that can be deducted against active or portfolio income because of the availability of the $25,000 allowance. ■

The $25,000 offset allowance is an aggregate of both deductions and credits in deduction equivalents. The deduction equivalent of a passive activity credit is the amount of deductions that reduces the tax liability for the taxable year by an amount equal to the credit.[49] A taxpayer with $5,000 of credits and a marginal tax rate of 25 percent would have a deduction equivalent of $20,000 ($5,000/25%).

If total deductions and deduction equivalents exceed $25,000, the taxpayer must allocate the benefit on a pro rata basis. First, the allowance must be allocated among the losses (including real estate rental activity losses suspended in prior years) and then to credits.

EXAMPLE 41

Kevin is an active participant in a real estate rental activity that produces $8,000 of income, $26,000 of deductions, and $1,500 of credits. Kevin, whose marginal tax rate is 25%, may deduct the net passive loss of $18,000 ($8,000 − $26,000). After deducting the loss, he has an available deduction equivalent of $7,000 ($25,000 − $18,000 passive loss). Therefore, the maximum amount of credits that he may claim is $1,750 ($7,000 × 25%). Since the actual credits are less than this amount, Kevin may claim the entire $1,500 credit. ■

[47] § 469(i).
[48] § 469(i)(6).
[49] § 469(j)(5).

EXAMPLE 57

Kelly, whose marginal tax rate is 25%, actively participates in three separate real estate rental activities. The relevant tax results for each activity are as follows:

- Activity A: $20,000 of losses.
- Activity B: $10,000 of losses.
- Activity C: $4,200 of credits.

Kelly's deduction equivalent from the credits is $16,800 ($4,200/25%). Therefore, the total passive deductions and deduction equivalents are $46,800 ($20,000 + $10,000 + $16,800), which exceeds the maximum allowable amount of $25,000. Consequently, Kelly must allocate pro rata first from among losses and then from among credits. Deductions from losses are limited as follows:

- Activity A: $25,000 × [$20,000/($20,000 + $10,000)] = $16,667.
- Activity B: $25,000 × [$10,000/($20,000 + $10,000)] = $8,333.

Since the amount of passive deductions exceeds the $25,000 maximum, the deduction balance of $5,000 and passive credits of $4,200 must be carried forward. Kelly's suspended losses and credits by activity are as follows:

		Activity		
	Total	A	B	C
Allocated losses	$ 30,000	$ 20,000	$10,000	$ –0–
Allocated credits	4,200	–0–	–0–	4,200
Utilized losses	(25,000)	(16,667)	(8,333)	–0–
Suspended losses	5,000	3,333	1,667	–0–
Suspended credits	4,200	–0–	–0–	4,200

■

DISPOSITION OF PASSIVE ACTIVITIES

LO.10

Determine the consequences of the disposition of passive activities.

Recall from an earlier discussion that if a taxpayer disposes of an entire interest in a passive activity, any suspended losses (and in certain cases, suspended credits) may be utilized when calculating the final economic gain or loss on the investment. In addition, if a loss ultimately results, that loss can offset other types of income. However, the consequences may differ if the activity is disposed of in a transaction that is not fully taxable. The following discusses the treatment of suspended passive losses in two such dispositions.

Disposition of a Passive Activity at Death

A transfer of a taxpayer's interest in an activity by reason of the taxpayer's death results in suspended losses being allowed (to the decedent) to the extent they exceed the amount, if any, of the step-up in basis allowed.[50] Suspended losses are lost to the extent of the amount of the basis increase. The losses allowed generally are reported on the final return of the deceased taxpayer.

EXAMPLE 58

A taxpayer dies with passive activity property having an adjusted basis of $40,000, suspended losses of $10,000, and a fair market value at the date of the decedent's death of $75,000. The increase (i.e., step-up) in basis (see Chapter 7) is $35,000 (fair market value at date of death in excess of adjusted basis). None of the $10,000 suspended loss is deductible by either the decedent or the beneficiary. The suspended losses ($10,000) are lost because they do not exceed the step-up in basis ($35,000). ■

EXAMPLE 59

A taxpayer dies with passive activity property having an adjusted basis of $40,000, suspended losses of $10,000, and a fair market value at the date of the decedent's death

[50] § 469(g)(2).

of $47,000. Since the step-up in basis is only $7,000 ($47,000 − $40,000), the suspended losses allowed are limited to $3,000 ($10,000 suspended loss at time of death − $7,000 increase in basis). The $3,000 loss available to the decedent is reported on the decedent's final income tax return. ■

Disposition of a Passive Activity by Gift

In a disposition of a taxpayer's interest in a passive activity by gift, the suspended losses are added to the basis of the property.[51]

EXAMPLE 54

A taxpayer makes a gift of passive activity property having an adjusted basis of $40,000, suspended losses of $10,000, and a fair market value at the date of the gift of $100,000. The taxpayer cannot deduct the suspended losses in the year of the disposition. However, the suspended losses of $10,000 transfer with the property and are added to the adjusted basis of the property in the hands of the donee. ■

When a passive activity is transferred by gift, the suspended losses become permanently nondeductible to both the donor and the donee. Nonetheless, a tax *benefit* may be available to the donee for another reason. Due to the increase in the property's basis, greater depreciation deductions can result, and there will be less gain (or more loss) on a subsequent sale of the property. The side benefits of increased basis do not materialize if the recipient is a charity, as such organizations generally are not subject to income taxation.

Tax Planning Strategies UTILIZING PASSIVE LOSSES

FRAMEWORK FOCUS: TAX RATE

Strategy: Control the Character of Income and Deductions.

Perhaps the biggest challenge individuals face with the passive loss rules is to recognize the potential impact of the rules and then to structure their affairs to minimize this impact. Taxpayers who have passive activity losses (PALs) should adopt a strategy of generating passive activity income that can be sheltered by existing passive losses. One approach is to buy an interest in a passive activity that is generating income (referred to as a passive income generator, or PIG). Then the PAL can offset income from the PIG. From a tax perspective, it would be foolish to buy a loss-generating passive activity unless one has passive income to shelter or the activity is rental real estate that can qualify for the $25,000 exception or the exception available to real estate professionals.

If a taxpayer does invest in an activity that produces losses subject to the passive loss rules, the following strategies may help to minimize the loss of current deductions:

- If money is borrowed to finance the purchase of a passive activity, the associated interest expense is generally treated as part of any passive loss. Consequently, by increasing the amount of cash used to purchase the passive investment, the investor will need less debt and will incur less interest expense. By incurring less interest expense, a possible suspended passive loss deduction is reduced.
- If the investor does not have sufficient cash readily available for the larger down payment, it can be obtained by borrowing against the equity in his or her personal residence. The interest expense on such debt will be deductible under the qualified residence interest provisions (see Chapter 16) and will not be subject to the passive loss limitations. Thus, the taxpayer avoids the passive loss limitation and secures a currently deductible interest expense.

Often unusable passive losses accumulate and provide no current tax benefit because the taxpayer has no passive income. When the taxpayer disposes of the entire interest in a passive activity, however, any suspended losses from that activity are used to reduce the taxable gain. If any taxable gain still remains, it can be offset by losses from other passive activities. As a result, the taxpayer should carefully select the year in which a passive activity is disposed of. It is to the taxpayer's advantage to wait until sufficient passive losses have accumulated to offset any gain recognized on the asset's disposition.

[51] § 469(j)(6).

EXAMPLE 9

Bill, a calendar year taxpayer, owns interests in two passive activities: Activity A, which he plans to sell in December of this year at a gain of $100,000; and Activity B, which he plans to keep indefinitely. Current and suspended losses associated with Activity B total $60,000, and Bill expects losses from the activity to be $40,000 next year. If Bill sells Activity A this year, the $100,000 gain can be offset by the current and suspended losses of $60,000 from Activity B, producing a net taxable gain of $40,000. However, if Bill delays the sale of Activity A until January of next year, the $100,000 gain will be fully offset by the $100,000 of losses generated by Activity B ($60,000 current and prior losses + $40,000 next year's loss). Consequently, by postponing the sale by one month, he could avoid recognizing $40,000 of gain that would otherwise result. ■

Taxpayers with passive losses should consider the level of their involvement in all other trades or businesses in which they have an interest. If they show that they do not materially participate in a profitable activity, the activity becomes a passive activity. Current and suspended passive losses then could shelter any income generated by the profitable business. Family partnerships in which certain members do not materially participate would qualify. The silent partner in any general partnership engaged in a trade or business would also qualify.

EXAMPLE 10

Gail has an investment in a limited partnership that produces annual passive losses of approximately $25,000. She also owns a newly acquired interest in a convenience store where she works. Her share of the store's income is $35,000. If she works enough to be classified as a material participant, her $35,000 share of income is treated as active income. This results in $35,000 being subject to tax every year, while her $25,000 loss is suspended. However, if Gail reduces her involvement at the store so that she is not a material participant, the $35,000 of income receives passive treatment. Consequently, the $35,000 of income can be offset by the $25,000 passive loss, resulting in only $10,000 being subject to tax. Thus, by reducing her involvement, Gail ensures that the income from the profitable trade or business receives passive treatment and can then be used to absorb passive losses from other passive activities. ■

The passive loss rules can have a dramatic effect on a taxpayer's ability to claim passive losses currently. As a result, it is important to keep accurate records of all sources of income and losses, particularly any suspended passive losses and credits and the activities to which they relate, so that their potential tax benefit will not be lost.

REFOCUS ON THE BIG PICTURE

RECEIVING TAX BENEFITS FROM LOSSES

While Robyn's circumstances were unfortunate, the good news is that she will be able to receive some tax benefits from the losses.

- *Bad debt.* Based on the facts provided, it appears that Robyn's loan to her friend was a bona fide nonbusiness bad debt. The amount of the loss deduction is the unpaid principal balance of $19,000 ($25,000 − $6,000). As a nonbusiness bad debt, the loss is classified as a short-term capital loss.
- *Loss from stock investment.* Likewise, the $60,000 loss on the stock investment is deductible. If Robyn purchased the stock directly from the company, the stock may qualify as small business stock under § 1244. If this is the case, the first $50,000 of the loss is an ordinary loss, and the remaining $10,000 loss is treated as a long-term capital loss. If the stock is not § 1244 stock, the entire $60,000 loss is treated as a long-term capital loss.
- *Loss from bookstore.* The $180,000 loss from the bookstore is reported on Schedule C of Robyn's Form 1040. It is an ordinary loss and qualifies for net operating loss (NOL) treatment if she does not have other income this year against which the loss could be offset. Any NOL can be carried back or carried forward to produce refunds of taxes paid from prior years or to reduce taxes owed on income earned in the future.

  Casualty loss. The loss from the damage to Robyn's personal residence is a personal casualty loss. Using the cost of repairs method, the amount of the casualty loss is $7,000 ($32,000 − $25,000 insurance recovery).

CONTINUED

However, this amount must be reduced by the statutory amount of $100 (in 2010) and 10 percent of AGI.

Passive activity loss. The $20,000 loss on the limited partnership is not deductible currently due to the passive loss limitation. However, the loss can be carried forward and utilized in the future to offset any passive income generated from the venture.

What If?

What if instead of operating orange groves the partnership owns and rents apartments to college students and Robyn actively participates in the venture? In this case, Robyn may qualify for a $20,000 ordinary loss deduction under the rental real estate exception.

SUGGESTED READINGS

Steven C. Colburn, "Passive Activities Can Have Dynamic Income Tax Implications," *Practical Tax Strategies*, February 2008.

James A. Fellows, Michael A. Yuhas, and John F. Jewell, "Passive Activity Losses: Learning to Live with the Self-Rental Rule," *Journal of Taxation*, January 2008.

Chris Fenn, "Investment and Tax Planning Strategies for Uncertain Economic Times," *Practical Tax Strategies*, September 2009.

Thomas I. Hausman, "Passive Activities and Real Estate Professionals," *Journal of Real Estate Taxation*, Second Quarter 2007.

KEY TERMS

Active income, 6–18
At-risk limitation, 6–15
Bad debt, 6–3
Business bad debt, 6–4
Casualty losses, 6–8
Closely held C corporation, 6–22
Disaster area losses, 6–9
Material participation, 6–24
Net operating losses (NOLs), 6–13
Nonbusiness bad debt, 6–4
Passive loss, 6–15
Personal service corporation, 6–22
Portfolio income, 6–18
Rental activity, 6–28
Reserve method, 6–3
Significant participation activity, 6–25
Small business stock (§ 1244 stock), 6–6
Specific charge-off method, 6–3
Tax shelters, 6–14
Theft losses, 6–8
Worthless securities, 6–6

PROBLEMS

COMMUNICATIONS

1. **LO.1** Several years ago, Loon Finance Company, which is in the lending business, loaned Sara $30,000 to purchase an automobile to be used for personal purposes. In August of the current year, Sara filed for bankruptcy, and Loon was notified that it could not expect to receive more than $4,000. As of the end of the current year, Loon has received $1,000. Loon has contacted you about the possibility of taking a bad debt deduction for the current year.

   Write a letter to Loon Finance Company that contains your advice as to whether it can claim a bad debt deduction for the current year. Also, prepare a memo for the tax files. Loon's address is 100 Tyler Lane, Erie, PA 16563.

2. **LO.1** Monty loaned his friend Ned $20,000 three years ago. Ned signed a note and made payments on the loan. Last year, when the remaining balance was $14,000, Ned filed for bankruptcy and notified Monty that he would be unable to pay the balance on the loan. Monty treated the $14,000 as a nonbusiness bad debt. Last year Monty had no capital

gains and a net operating loss of $12,000. During the current year, Ned paid Monty $2,000 in satisfaction of the debt. Determine Monty's tax treatment for the $2,000 received in the current year.

3. **LO.2** Many years ago, Jack purchased 400 shares of Canary stock. During the current year, the stock became worthless. It was determined that the company "went under" because several corporate officers embezzled a large amount of company funds. Identify the relevant tax issues for Jack.

ISSUE ID

4. **LO.1** Jake and Mary Snow are residents of the state of New York. They are cash basis taxpayers and file a joint return for the calendar year. Jake is a licensed master plumber. Two years ago, Jake entered into a contract with New York City to perform plumbing services. During the current year, Jake was declared to be in breach of the contract, and he ceased performing plumbing services. Jake received a Form W–2 that reported $50,000 for wages paid. He also maintains that the city has not paid him $35,000 for work he performed. Jake is considering claiming a $35,000 business bad debt on his tax return. Evaluate Jake's plan.

ETHICS AND EQUITY

5. **LO.1, 2** Mable and Jack file a joint return. For the current year, they had the following items:

Salaries	$180,000
Loss on sale of § 1244 stock acquired two years ago	105,000
Gain on sale of § 1244 stock acquired six months ago	20,000
Nonbusiness bad debt	19,000

Determine the impact of the above items on Mable and Jack's income for the current year.

6. **LO.2** Mary, a single taxpayer, purchased 10,000 shares of § 1244 stock several years ago at a cost of $20 per share. In November of the current year, Mary receives an offer to sell the stock for $12 per share. She has the option of either selling all of the stock now or selling half of the stock now and half of the stock in January of next year. Mary's salary is $80,000 for the current year, and it will be $90,000 next year. Mary has long-term capital gains of $8,000 for the current year and will have $10,000 next year. If Mary's goal is to minimize her AGI for the two years, determine whether she should sell all of her stock this year or half of her stock this year and half next year.

DECISION MAKING

7. **LO.2** Paul Sanders, a married taxpayer who files a joint return with his wife, acquired stock in a corporation that qualified as a small business corporation under § 1244. The stock cost $30,000 and was acquired three years ago. A few months after he acquired the stock he gave it to his brother, Mike Sanders. The stock was worth $30,000 on the date of the gift. Mike, who is married and files a joint return with his wife, sells the stock for $10,000 in the current tax year. You represent Mike who asks you whether he can take a loss deduction on the sale of the stock. If so, how will the loss be treated for tax purposes? Prepare a letter to your client and a memo to the files. Mike's address is 2600 Riverview Drive, Plank, MO 63701.

CRITICAL THINKING

COMMUNICATIONS

8. **LO.3** Grackle Farming, Inc., owns a 500-acre farm in Minnesota. A tornado hit the area and destroyed a farm building and some farm equipment and damaged a barn. Fortunately for Grackle, the tornado occurred after the company had harvested its corn crop. Applicable information is as follows:

DECISION MAKING

Asset	Basis	FMV Before	FMV After	Insurance Recovery
Building	$90,000	$ 70,000	$ –0–	$70,000
Equipment	40,000	50,000	–0–	25,000
Barn	90,000	120,000	70,000	25,000

Because of the extensive damage caused by the tornado, the President of the United States designated the area as a disaster area.

Grackle had $95,000 of taxable income last year. The company's taxable income for the current year, excluding the loss from the tornado, is $250,000. Determine the amount of the corporation's loss and the year in which it should take the loss.

ISSUE ID

9. **LO.3** In 2007, John opened an investment account with Randy Hansen who held himself out to the public as an investment adviser and securities broker. John contributed $200,000 to the account in 2007. John provided Randy with a power of attorney to use the $200,000 to purchase and sell securities on John's behalf. John instructed Randy to reinvest any gains and income earned. In the years 2007, 2008, and 2009, John received statements of the amount of income earned by his account and included these amounts in his gross income for these years. In 2010, it was discovered that Randy's purported investment advisory and brokerage activity was in fact a fraudulent investment arrangement known as a "Ponzi" scheme. In reality, John's account balance was zero, the money having been used by Randy in his scheme. Identify the relevant tax issues for John.

DECISION MAKING

COMMUNICATIONS

10. **LO.3** On November 1 of the current year, Sam dropped off to sleep while driving home from a business trip. Luckily, he was only slightly injured in the resulting accident, but the company car that he was driving was damaged significantly.

Sam is an employee of Snipe Industries. The corporation purchased the car new two years ago for $40,000. The automobile had a fair market value of $30,000 before the accident and $12,000 after the accident. The car was covered by an insurance policy that had a $3,000 deductible clause. The corporation is afraid that the policy will be canceled if it makes a claim for the damages. Therefore, Snipe is considering not filing a claim. The company believes that the casualty loss deduction will help mitigate the loss of the insurance reimbursement. The corporation's taxable income for the current year is $25,000.

Write a letter to Snipe Industries that contains your advice regarding the filing of an insurance claim for reimbursement for the damages to the company's car. Snipe Industries' address is 450 Colonel's Way, Warrensburg, MO 64093.

CRITICAL THINKING

11. **LO.4** Mary, a single taxpayer with two dependent children, has the following items of income and expense during 2010:

Gross receipts from business	$144,000
Business expenses	180,000
Alimony received	22,000
Interest income	40,000
Itemized deductions (no casualty or theft)	28,000

a. Determine Mary's taxable income for 2010.
b. Determine Mary's NOL for 2010.

12. **LO.6** In 2009, Fred invested $50,000 in a general partnership. Fred's interest is not considered to be a passive activity. If his share of the partnership losses is $35,000 in 2009 and $25,000 in 2010, how much can he deduct in each year?

COMMUNICATIONS

13. **LO.6** In the current year, Bill Parker (54 Oak Drive, St. Paul, MN 55162) is considering making an investment of $60,000 in Best Choice Partnership. The prospectus provided by Bill's broker indicates that the partnership investment is not a passive activity and that Bill's share of the entity's loss in the current year will likely be $40,000, while his share of the partnership loss next year will probably be $25,000. Write a letter to Bill in which you indicate how the losses would be treated for tax purposes in the current and next years.

ISSUE ID

14. **LO.6, 7, 8** In the current year, George and Susie Melvin, both successful CPAs, made a cash investment in a limited partnership interest in a California orange grove. In addition to the cash generated from the investors, the venture borrowed a substantial sum to purchase assets necessary for its operation. The Melvins' investment adviser told them that their share of the tax loss in the first year alone would be in excess of their initial cash investment. This result would be followed by several more years of losses. They feel confident that their interest in the orange grove is a sound investment. Identify the tax issues facing the Melvins.

15. **LO.6** In 2005, Russell acquired an interest in a partnership in which he is not a material participant. The partnership was profitable through 2008, and Russell's basis in this partnership interest at the beginning of 2009 was $50,000. Russell's share of the partnership loss was $40,000 in 2009, and his share of the partnership income is $22,000 in 2010. How much can Russell deduct for 2009 and 2010?

16. **LO.5, 6** Hazel has investments in two nonrental passive activities. Activity A, acquired seven years ago, was extremely profitable until the current year. Activity B was acquired this year. Currently, Hazel's share of the losses is $10,000 from Activity A and $6,000 from Activity B. What is the total amount of Hazel's suspended losses from these activities as of the end of the current year?

17. **LO.6** Sarah has investments in four passive activity partnerships purchased several years ago. Last year, the income and losses were as follows:

Activity	Income (Loss)
A	$ 10,000
B	(5,000)
C	(25,000)
D	(20,000)

In the current year, she sold her interest in Activity D for a $19,000 gain. Activity D, which had been profitable until last year, had a current loss of $1,000. How will the sale of Activity D affect Sarah's taxable income in the current year?

18. **LO.6** Leon sells his interest in a passive activity for $100,000. Determine the tax effect of the sale based on each of the following independent facts:
    a. Adjusted basis in this investment is $35,000. Losses from prior years that were not deductible due to the passive loss restrictions total $40,000.
    b. Adjusted basis in this investment is $75,000. Losses from prior years that were not deductible due to the passive loss restrictions total $40,000.
    c. Adjusted basis in this investment is $75,000. Losses from prior years that were not deductible due to the passive loss restrictions total $40,000. In addition, suspended credits total $10,000.

19. **LO.6** In the current year, White, Inc., earns $400,000 from operations and receives $36,000 in dividends and interest on various portfolio investments. White also pays $150,000 to acquire a 20% interest in a passive activity that produces a $200,000 loss.
    a. Assuming White is a personal service corporation, how will these transactions affect its taxable income?
    b. Same as (a), except that White is closely held but not a personal service corporation.

20. **LO.6** Brown Corporation, a personal service corporation, earns active income of $200,000 and receives $60,000 in dividends during the year. In addition, Brown incurs a loss of $45,000 from an investment in a passive activity acquired three years ago. What is Brown's total income for the current year after considering the passive investment?

21. **LO.6, 7** Greg Horne (431 Maple Avenue, Cincinnati, OH 45229), a syndicated radio talk show host, earns an annual salary of $400,000. He works approximately 30 hours per week in this job, which leaves him time to participate in several businesses newly acquired in 2010. He owns a movie theater and a drugstore in Cincinnati, a movie theater and a drugstore in Indianapolis, and a drugstore in Louisville. A preliminary analysis on December 1, 2010, shows the following projected income and losses and time spent for these various businesses.

DECISION MAKING

COMMUNICATIONS

	Income (Loss)
Cincinnati movie theater (95 hours)	$ 56,000
Cincinnati drugstore (140 hours)	(89,000)
Indianapolis movie theater (90 hours)	34,000
Indianapolis drugstore (170 hours)	(41,000)
Louisville drugstore (180 hours)	(15,000)

Greg has full-time employees in each of the five businesses. Write a letter to Greg suggesting a grouping method and other strategies that will provide the greatest tax advantage. As Greg is not knowledgeable about tax law, provide a nontechnical explanation.

DECISION MAKING

22. **LO.7** Suzanne owns interests in a bagel shop, a lawn and garden store, and a convenience store. Several full-time employees work at each of the enterprises. As of the end of November of the current year, Suzanne has worked 150 hours in the bagel shop, 250 hours at the lawn and garden store, and 70 hours at the convenience store. In reviewing her financial records, you learn that she has no passive investments that are generating income and that she expects these three ventures collectively to produce a loss. What recommendation would you offer Suzanne as she plans her activities for the remainder of the year?

ISSUE ID

23. **LO.7** Rene retired from public accounting after a long and successful career of 45 years. As part of her retirement package, she continues to share in the profits and losses of the firm, albeit at a lower rate than when she was working full-time. Because Rene wants to stay busy during her retirement years, she has invested and works in a local hardware business, operated as a partnership. Unfortunately, the business has recently gone through a slump and has not been generating profits. Identify relevant tax issues for Rene.

CRITICAL THINKING

DECISION MAKING

24. **LO.7** Last year, Juan, a real estate developer, purchased 25 acres of farmland on the outskirts of town for $100,000. He expects that the land's value will appreciate rapidly as the town expands in that direction. Since the property was recently reappraised at $115,000, some of the appreciation has already taken place. To enhance his return from the investment, Juan decides he will begin renting the land to a local farmer. He has determined that a fair rent would be at least $1,500 but no more than $3,500 per year. Juan also has an interest in a passive activity that generates a $2,800 loss annually. How do the passive loss rules affect Juan's decision on how much rent to charge for the farmland?

DECISION MAKING

25. **LO.8** The end of the year is approaching, and Maxine has begun to focus on ways of minimizing her income tax liability. Several years ago, she purchased an investment in Teal Limited Partnership, which is subject to both the at-risk and the passive activity loss rules. (Last year, Maxine sold a different investment that was subject to these rules but produced passive income.) She believes that her investment in Teal has good long-term economic prospects. However, it has been generating tax losses for several years in a row. In fact, when she was discussing last year's income tax return with her tax accountant, he said that unless "things change" with respect to her investments, she would not be able to deduct losses this year.
    a. What was the accountant referring to in his comment?
    b. You learn that Maxine's current at-risk basis in her investment is $1,000 and her share of the current loss is expected to be $13,000. Based on these facts, how will her loss be treated?
    c. After reviewing her situation, Maxine's financial adviser suggests that she invest at least an additional $12,000 in Teal in order to ensure a full loss deduction in the current year. How do you react to his suggestion?
    d. What would you suggest Maxine consider as she attempts to maximize her current-year deductible loss?

26. **LO.8** A number of years ago, Lee acquired a 20% interest in the BlueSky Partnership for $60,000. The partnership was profitable through 2009, and Lee's amount at risk in the partnership interest was $120,000 at the beginning of 2010. BlueSky incurred a loss of $400,000 in 2010 and reported income of $200,000 in 2011. Assuming Lee is not a material participant, how much of his loss from BlueSky Partnership is deductible in 2010 and 2011? Consider both the at-risk and the passive loss rules.

27. **LO.8** Last year, Fran invested $40,000 for an interest in a partnership in which she is a material participant. Her share of the partnership loss for last year was $50,000. In the current year, Fran's share of the partnership's income is $30,000. What is the effect on her taxable income for the current year?

28. **LO.5, 6, 8** Jonathan, a physician, earns $200,000 from his practice. He also receives $18,000 in dividends and interest on various portfolio investments. During the year, he pays $45,000 to acquire a 20% interest in a partnership that produces a $300,000 loss. Compute Jonathan's AGI, assuming that:
    a. He does not participate in the operations of the partnership.
    b. He is a material participant in the operations of the partnership.

29. **LO.5, 6, 8** Five years ago, Gerald invested $150,000 in a passive activity, his sole investment venture. On January 1, 2009, his amount at risk in the activity was $30,000. His shares of the income and losses were as follows:

Year	Income (Loss)
2009	($40,000)
2010	(30,000)
2011	50,000

Gerald holds no suspended at-risk or passive losses at the beginning of 2009. How much can Gerald deduct in 2009 and 2010? What is his taxable income from the activity in 2011? Consider the at-risk rules as well as the passive loss rules.

30. **LO.9** Several years ago, Rachel acquired an apartment building that currently generates a loss of $35,000. She has AGI of $120,000 before considering the loss. If Rachel is not an active participant in the activity, what is the effect of the loss on her AGI?

31. **LO.5, 6, 7** You have just met with Scott Myers (603 Pittsfield Dr., Champaign, IL 61821), a successful full-time real estate developer and investor. During your meeting you discussed his tax situation, because you are starting to prepare his 2009 Federal income tax return. During your meeting, Scott mentioned that he and his wife, Susan, went to great lengths to maximize their participation in an apartment complex that they own and manage. In particular, Scott included the following activities in the 540 hours of participation for the current year:

ETHICS AND EQUITY

COMMUNICATIONS

- Time spent thinking about the rentals.
- Time spent by Susan on weekdays visiting the apartment complex to oversee operations of the buildings (i.e., in a management role).
- Time spent by both Scott and Susan on weekends visiting the apartment complex to assess operations. Scott and Susan always visited the complex together on weekends and both counted their hours (i.e., one hour at the complex was two hours of participation).
- Time spent on weekends driving around the community looking for other potential rental properties to purchase. Again, both Scott's hours and Susan's hours were counted, even when they drove together.

After reviewing Scott's records, you note that the apartment complex generated a significant loss this year. Prepare a letter to Scott describing your position on the deductibility of the loss.

32. **LO.6, 8** Bonnie and Adam are married with no dependents and live in New Hampshire (not a community property state). Since Adam has large medical expenses, they seek your advice about filing separately to save taxes. Their income and expenses for 2010 are as follows:

DECISION MAKING

Bonnie's salary	$44,000
Adam's salary	30,000
Interest income (joint)	1,500
Rental loss from actively managed rental property	23,000
Adam's unreimbursed medical expenses	9,500
All other itemized deductions:*	
Bonnie	10,000
Adam	3,500

*None subject to limitations.

Determine whether Bonnie and Adam should file jointly or separately for 2010.

33. **LO.8** During the current year, Maria works 1,200 hours as a computer consultant, 320 hours in her real estate development business, and 400 hours in her real estate rental activities. Larry, her husband, works 250 hours in Maria's real estate development business and 180 hours in her real estate rental business. Maria earns $60,000 as a computer consultant, but she and Larry lose $18,000 in the real estate development business and $26,000 in the real estate rental business. How should they treat the losses on their Federal income tax return?

34. **LO.8** Ida, who has AGI of $80,000 before considering rental activities, is active in three separate real estate rental activities. Ida has a marginal tax rate of 28%. She has $12,000 of losses from Activity A, $18,000 of losses from Activity B, and income of $10,000 from Activity C. She also has $2,100 of tax credits from Activity A. Calculate her deductions and credits allowed and the suspended losses and credits.

35. **LO.8** Ella has $105,000 of losses from a real estate rental activity in which she actively participates. She has other rent income of $25,000 and other passive income of $32,000. How much rental loss can Ella deduct against active and portfolio income (ignoring the at-risk rules)? Does she have any suspended losses to carry over?

ETHICS AND EQUITY

36. **LO.5, 6, 9** Lucien dies in the current year owning a limited partnership interest in a partnership that owns and operates an apartment complex. Associated with Lucien's interest is a $10,000 suspended passive activity loss that he had not been able to claim. Ron, the executor of Lucien's estate, learns from the partnership's general partner that she is not aware of any recent qualified appraisals or sales that would help determine the fair market value of the limited partnership interest. Ron feels that the cost of hiring a qualified appraiser to determine the value of the interest is not necessary because Lucien's estate is not large enough to be subject to the Federal estate tax. Lucien's records reflect a basis of $65,000 for the partnership interest immediately before his death.

    The partnership's bookkeeper has a "gut feeling" that the partnership interest is worth anywhere between $65,000 and $80,000. This is good news to Ron. Based on her "guesstimate," Ron sets the value of the interest at $65,000.

    What is Ron trying to accomplish in setting this valuation? What ethical issues arise?

37. **LO.5, 6, 9** In the current year, Abe gives an interest in a passive activity to his daughter, Andrea. The value of the interest at the date of the gift is $25,000, and its adjusted basis to Abe is $13,000. During the time that Abe owned the investment, losses of $3,000 could not be deducted because of the passive loss limitations. What is the tax treatment of the suspended passive activity losses to Abe and to Andrea?

Bridge DISCIPLINE

1. Marketplace, Inc., has recognized over time that a certain percentage of its customer accounts receivable will not be collected. To ensure the appropriate matching of revenues and expenditures in its financial reports, Marketplace uses the reserve method for bad debts. Records show the following pertaining to its treatment of bad debts.

Beginning allowance for bad debts	$120,000
Ending allowance for bad debts	123,000
Bad debts written off during the year	33,000

    a. What was the bad debt expense for financial accounting purposes during the year?
    b. What was the bad debt expense for income tax purposes during the year?
    c. Assuming the before-tax net income for financial accounting purposes was $545,000, what is the taxable income for the year if the treatment of bad debts is the only book/tax difference?

DECISION MAKING

2. Heather wishes to invest $45,000 in a relatively safe venture and has discovered two alternatives that would produce the following ordinary income and loss over the next three years:

Year	Alternative 1 Income (Loss)	Alternative 2 Income (Loss)
1	($ 30,000)	($50,000)
2	(30,000)	34,000
3	84,000	40,000

    She is interested in the after-tax effects of these alternatives over a three-year horizon. Assume that:

    - Heather's investment portfolio produces sufficient passive income to offset any potential passive loss that may arise from these alternatives.

Heather's marginal tax rate is 25%, and her cost of capital is 6% (the present value factors are 0.9434, 0.8900, and 0.8396).

Each investment alternative possesses equal growth potential and comparable financial risk.

In the loss years for each alternative, there is no cash flow from or to the investment (i.e., the loss is due to depreciation), while in those years when the income is positive, cash flows to Heather equal the amount of the income.

Based on these facts, compute the present value of these two investment alternatives and determine which option Heather should choose.

3. Emily has $100,000 that she wishes to invest and is considering the following two options: **DECISION MAKING**

Option A: Investment in Redbird Mutual Fund, which is expected to produce interest income of $8,000 per year.

Option B: Investment in Cardinal Limited Partnership (buys, sells, and operates wine vineyards). Emily's share of the partnership's ordinary income and loss over the next three years would be:

Year	Income (Loss)
1	($ 8,000)
2	(2,000)
3	34,000

Emily is interested in the after-tax effects of these alternatives over a three-year horizon. Assume that Emily's investment portfolio produces ample passive income to offset any passive losses that may be generated. Her cost of capital is 8% (the present value factors are 0.92593, 0.85734, and 0.79383), and she is in the 28% tax bracket. The two investment alternatives possess equal growth potential and comparable financial risk. Based on these facts, compute the present value of these two investment alternatives and determine which option Emily should choose.

RESEARCH PROBLEMS

Note: Solutions to Research Problems can be prepared by using the **Checkpoint® Student Edition** online research product, which is available to accompany this text. It is also possible to prepare solutions to the Research Problems by using tax research materials found in a standard tax library.

THOMSON REUTERS
Checkpoint® Student Edition

Research Problem 1. Henry Hansen is a real estate developer. He was successful for many years. Three years ago, however, the real estate market crashed, and Henry reported losses for the two following tax years. The IRS disputed these losses and assessed tax deficiencies of $300,000 and $200,000 for the two years in question. In March of the current year, Henry offered to resolve all issues relating to those two years by paying the IRS $250,000 or $125,000 for each year. In April of the current year, the Commissioner accepted Henry's offer without discussion or negotiation. Henry now finds that he has an NOL for last year. If he carries the NOL back to the two years for which he has reached a settlement with the IRS, the stipulated tax deficiency will be eliminated. Discuss whether Henry will be allowed to carry his NOL back to the two prior years for which he has reached a settlement.

Research Problem 2. Lane Mitchell (77 Lakeview Drive, Salt Lake City, UT 84109) is a married individual who files a separate return for the taxable year. He is employed full-time as an accountant and also owns an interest in a minor league baseball team. He does no work in connection with the baseball activity and anticipates that it will produce a loss. He pays his wife to work as an office receptionist in connection with the activity. Her work requires an average of 20 hours a week. Write a letter to Lane and explain whether he will be allowed to deduct his share of the loss from the activity. **COMMUNICATIONS**

DECISION MAKING

COMMUNICATIONS

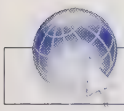
Research Problem 3. Over the years, Julie Hoyle (117 Western Avenue, Peoria, IL 61604) has taken great pride in her ability to spot exceptional rental real estate investments, particularly in terms of their appreciation potential. As a result, she has accumulated several properties. In the past, she was able to devote only a limited amount of time to these ventures. In the current year, however, she retires from her full-time job and devotes most of her time to the management and operation of the rental activities. The relevant tax attributes of each of Julie's properties are as follows:

Property	Suspended Passive Losses	Expected Current Year's Income (Loss)
A	None	$ 25,000
B	($ 20,000)	15,000
C	(40,000)	(15,000)

Julie has enough understanding of the tax law to know that she is a qualifying real estate professional for the current year and materially participates in all three properties within the meaning of § 469(c)(7). However, she is uncertain whether she should treat the properties as three separate activities or aggregate them as one activity.

Write a letter to Julie to assist her in making the decision. Because of Julie's expertise in the tax law, feel free to use technical language in your letter.

Partial list of research aids:
Reg. § 1.469–9(e).



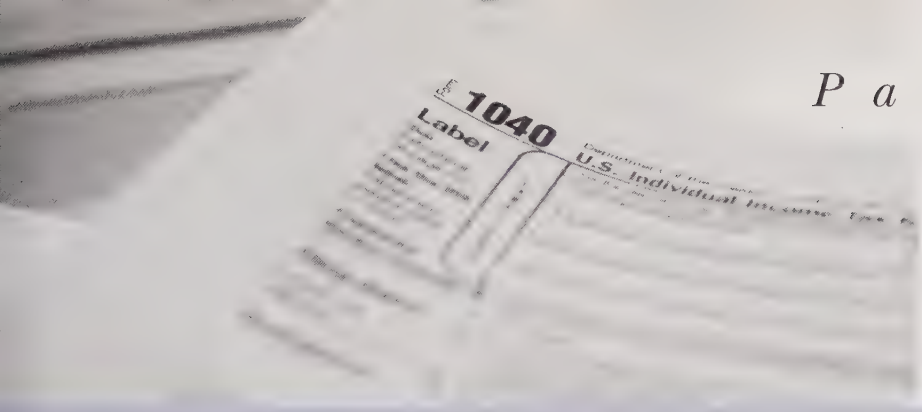
INTERNET *activity*

Use the tax resources of the Internet to address the following questions. Do not restrict your search to the Web, but include a review of newsgroups and general reference materials, practitioner sites and resources, primary sources of the tax law, chat rooms and discussion groups, and other opportunities.

COMMUNICATIONS

Research Problem 4. Scan several publications that are read by owners of small businesses. Some of the articles in these publications address tax-related issues such as how to structure a new business. Do these articles do an adequate job of conveying the benefits of issuing § 1244 small business stock? Prepare a short memo explaining the use of § 1244 stock and post it to a newsgroup that is frequented by inventors, engineers, and others involved in startup corporations.

Research Problem 5. Oil and gas ventures operating as publicly traded partnerships typically attract sophisticated investors who purchase limited partnership interests. Investments in these types of publicly traded partnerships are subject to a restrictive set of passive loss rules. Identify three oil and gas publicly traded partnerships that are currently marketed to new investors, and describe the benefits the promoters claim will result from such investments.



Part 3

Property Transactions

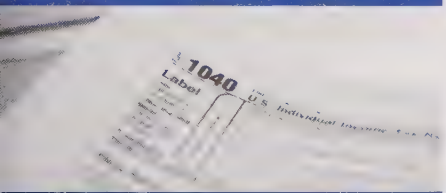
CHAPTER 7 Property Transactions: Basis, Gain and Loss, and Nontaxable Exchanges

CHAPTER 8 Property Transactions: Capital Gains and Losses, Section 1231, and Recapture Provisions

Part 3 presents the tax treatment of sales, exchanges, and other dispositions of property. Included are the determination of the realized gain or loss, recognized gain or loss, and the classification of the recognized gain or loss as capital or ordinary. The topic of basis is evaluated both in terms of its effect on the calculation of the gain or loss and in terms of the determination of the basis of any contemporaneous or related subsequent acquisitions of property.

CHAPTER 7

Property Transactions: Basis, Gain and Loss, and Nontaxable Exchanges



LEARNING OBJECTIVES

After completing Chapter 7, you should be able to:

LO.1 Understand the **computation of realized gain or loss** on property dispositions. **(pp. 7-3 to 7-6)**

LO.2 **Distinguish between realized and recognized** gain or loss. **(pp. 7-6 to 7-8)**

LO.3 Explain **how basis is determined** for various methods of asset acquisition. **(pp. 7-8 to 7-16)**

LO.4 Describe various **loss disallowance provisions**. **(pp. 7-16 to 7-18)**

LO.5 Apply the nonrecognition provisions and basis determination rules for **like-kind exchanges**. **(pp. 7-20 to 7-27)**

LO.6 Explain the nonrecognition provisions available on the **involuntary conversion** of property. **(pp. 7-27 to 7-31)**

LO.7 Identify **other nonrecognition provisions** contained in the Code. **(pp. 7-31 to 7-33)**

TAX *Talk*

To base all of your decisions on tax consequences is not necessarily to maintain the proper balance and perspective on what you are doing.

—Barber Conable

OUTLINE

7.1 Determination of Gain or Loss, 7-3
Realized Gain or Loss, 7-3
Recognized Gain or Loss, 7-6
Nonrecognition of Gain or Loss, 7-7
Recovery of Capital Doctrine, 7-7
7.2 Basis Considerations, 7-8
Determination of Cost Basis, 7-8
Gift Basis, 7-11
Property Acquired from a Decedent, 7-14
Disallowed Losses, 7-16
Conversion of Property from Personal Use to Business or Income-Producing Use, 7-17
Summary of Basis Adjustments, 7-18
7.3 General Concept of a Nontaxable Exchange, 7-18
7.4 Like-Kind Exchanges—§ 1031, 7-20
Like-Kind Property, 7-21
Exchange Requirement, 7-23
Boot, 7-24
Basis and Holding Period of Property Received, 7-25
7.5 Involuntary Conversions—§ 1033, 7-27
Involuntary Conversion Defined, 7-28
Replacement Property, 7-29
Time Limitation on Replacement, 7-30
7.6 Other Nonrecognition Provisions, 7-31
Transfer of Assets to Business Entity—§§ 351 and 721, 7-31
Exchange of Stock for Property—§ 1032, 7-31
Certain Exchanges of Insurance Policies—§ 1035, 7-31
Exchange of Stock for Stock of the Same Corporation—§ 1036, 7-31
Rollovers into Specialized Small Business Investment Companies—§ 1044, 7-32
Sale of a Principal Residence—§ 121, 7-32
Transfers of Property between Spouses or Incident to Divorce—§ 1041, 7-33

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CALCULATING BASIS AND RECOGNIZED GAIN FOR PROPERTY TRANSACTIONS

Alice owns land that she received from her father 10 years ago as a gift. The land was purchased by her father in 1980 for $2,000 and was worth $10,000 at the time of the gift. The property is currently worth about $50,000. Alice is considering selling the land and purchasing a piece of undeveloped property in the mountains.

Alice also owns 500 shares of stock, 300 of which were acquired as an inheritance when her grandfather died in 1985. Alice's grandfather paid $12,000 for the shares, and the shares were worth $30,000 at the time of his death. The other 200 shares were purchased by Alice two months ago for $28,000. The stock is currently worth $120 per share, and Alice is considering selling the shares.

Finally, Alice owns a house that she inherited from her grandmother two years ago. Her grandmother lived in the house for over 50 years. Alice has many fond memories associated with the house since she spent many summer vacations there and has been reluctant to sell the house. However, a developer has recently purchased several homes in the area and has offered Alice $600,000 for the property. Based on the estate tax return, the fair market value of the house at the date of her grandmother's death was $475,000. According to her grandmother's attorney, her grandmother's basis for the house was $275,000. Alice is considering selling the house. She expects any selling expenses to be minimal since she already has identified a buyer for the property.

Alice has come to you for tax advice with respect to the property she owns. What is the recognized gain or loss for the land, stock, and house if they are sold? Can Alice avoid paying taxes on any of the sales? **Read the chapter and formulate your response.**

This chapter and the following chapter are concerned with the income tax consequences of property transactions, including the sale or other disposition of property. The following questions are considered with respect to the sale or other disposition of property:

- Is there a realized gain or loss?
- If so, is that gain or loss recognized for tax purposes?
- If that gain or loss is recognized, is it ordinary or capital?
- What is the basis of any replacement property that is acquired?

This chapter discusses the determination of realized and recognized gain or loss and the basis of property. The following chapter covers the classification of recognized gain or loss as ordinary or capital.

For the most part, the rules discussed in Chapters 7 and 8 apply to all types of taxpayers. Individuals, partnerships, closely held corporations, limited liability companies, and publicly held corporations all own assets for use in business activities or as investments in entities that themselves conduct business activities. Individuals, however, are unique among taxpayers because they also own assets that are used in daily life and have no significant business or investment component. Because of that possibility, some property transaction concepts apply somewhat differently to individual taxpayers depending upon how a person uses the specific asset in question. Nevertheless, the material that follows pertains to taxpayers generally except where otherwise noted.

7.1 Determination of Gain or Loss

REALIZED GAIN OR LOSS

LO.1

Understand the computation of realized gain or loss on property dispositions.

For tax purposes, gain or loss is the difference between the *amount realized* from the sale or other disposition of property and the property's *adjusted basis* on the date of disposition. If the amount realized exceeds the property's adjusted basis, the result is a **realized gain.** Conversely, if the property's adjusted basis exceeds the amount realized, the result is a **realized loss.**[1]

EXAMPLE 1

Lavender, Inc., sells Swan Corporation stock with an adjusted basis of $3,000 for $5,000. Lavender's realized gain is $2,000. If Lavender had sold the stock for $2,000, it would have had a realized loss of $1,000. ■

Sale or Other Disposition

The term *sale or other disposition* is defined broadly to include virtually any disposition of property. Thus, trade-ins, casualties, condemnations, thefts, and bond retirements are all treated as dispositions of property. The most common disposition of property is a sale or exchange. Usually, the key factor in determining whether a disposition has taken place is whether an identifiable event has occurred[2] as opposed to a mere fluctuation in the value of the property.[3]

EXAMPLE 2

Heron & Associates owns Tan Corporation stock that cost $3,000. The stock has appreciated in value by $2,000 since Heron purchased it. Heron has no realized gain since mere fluctuation in value is not a disposition or identifiable event for tax purposes. Nor would Heron have a realized loss had the stock declined in value. ■

Amount Realized

The **amount realized** from a sale or other disposition of property is the sum of any money received plus the fair market value of other property received. The amount realized also includes any real property taxes treated as imposed on the seller that are actually paid by the buyer.[4] The reason for including these taxes in the amount realized is that by paying the taxes, the purchaser is, in effect, paying an additional amount to the seller of the property.

The amount realized also includes any liability on the property disposed of, such as a mortgage debt, if the buyer assumes the mortgage or the property is sold subject to the mortgage.[5] The amount of the liability is included in the amount realized, even if the debt is nonrecourse and even if the amount of the debt is greater than the fair market value of the mortgaged property.[6]

[1] § 1001(a) and Reg. § 1.1001–1(a).

[2] Reg. § 1.1001–1(c)(1).

[3] *Lynch v. Turrish*, 1 USTC ¶18, 3 AFTR 2986, 38 S.Ct. 537 (USSC, 1918).

[4] § 1001(b) and Reg. § 1.1001–1(b).

[5] *Crane v. Comm.*, 47–1 USTC ¶9217, 35 AFTR 776, 67 S.Ct. 1047 (USSC, 1947). Although a legal distinction exists between the direct assumption of a mortgage and taking property subject to a mortgage, the tax consequences in calculating the amount realized are the same.

[6] *Comm. v. Tufts*, 83–1 USTC ¶9328, 51 AFTR 2d 83–1132, 103 S.Ct. 1826 (USSC, 1983).

EXAMPLE 1

Bunting & Co. sells property to Orange, Inc., for $50,000 cash. There is a $20,000 mortgage on the property. Bunting's amount realized from the sale is $70,000 if Orange assumes the mortgage or takes the property subject to the mortgage. ■

The **fair market value** of property received in a sale or other disposition has been defined by the courts as the price at which the property will change hands between a willing seller and a willing buyer when neither is compelled to sell or buy.[7] Fair market value is determined by considering the relevant factors in each case.[8] An expert appraiser is often required to evaluate these factors in arriving at fair market value. When the fair market value of the property received cannot be determined, the value of the property given up by the taxpayer may be used.[9]

In calculating the amount realized, selling expenses such as advertising, commissions, and legal fees relating to the disposition are deducted. The amount realized is the net amount that the taxpayer received directly or indirectly, in the form of cash or anything else of value, from the disposition of the property.

Adjusted Basis

The **adjusted basis** of property disposed of is the property's original basis adjusted to the date of disposition.[10] Original basis is the cost or other basis of the property on the date the property is acquired by the taxpayer. Considerations involving original basis are discussed later in this chapter. *Capital additions* increase and *recoveries of capital* decrease the original basis so that on the date of disposition the adjusted basis reflects the unrecovered cost or other basis of the property.[11] Adjusted basis is determined as follows:

Cost (or other adjusted basis) on date of acquisition
+ Capital additions
−Capital recoveries
= Adjusted basis on date of disposition

Capital Additions

Capital additions include the cost of capital improvements and betterments made to the property by the taxpayer. These expenditures are distinguishable from expenditures for the ordinary repair and maintenance of the property, which are neither capitalized nor added to the original basis (refer to Chapter 5). The latter expenditures are deductible in the current taxable year if they are related to business or income-producing property. Amounts representing real property taxes treated as imposed on the seller but paid or assumed by the buyer are part of the cost of the property.[12] Any liability on property that is assumed by the buyer is also included in the buyer's original basis of the property. The same rule applies if property is acquired subject to a liability. In a similar fashion, amortization of the discount on bonds increases the adjusted basis of the bonds.[13]

EXAMPLE 2

Bluebird Corporation purchased some manufacturing equipment for $25,000. Whether Bluebird uses $25,000 from the business's cash account to pay for this equipment or uses $5,000 from that account and borrows the remaining $20,000, the basis of this equipment will be the same—namely, $25,000. Moreover, it does not matter whether Bluebird borrowed the $20,000 from the equipment's manufacturer, from a local bank, or from any other lender. ■

[7] *Comm. v. Marshman*, 60–2 USTC ¶9484, 5 AFTR 2d 1528, 279 F.2d 27 (CA–6, 1960).

[8] *O'Malley v. Ames*, 52–1 USTC ¶9361, 42 AFTR 19, 197 F.2d 256 (CA–8, 1952).

[9] *U.S. v. Davis*, 62–2 USTC ¶9509, 9 AFTR 2d 1625, 82 S.Ct. 1190 (USSC, 1962).

[10] § 1011(a) and Reg. § 1.1011–1.

[11] § 1016(a) and Reg. § 1.1016–1.

[12] Reg. §§ 1.1001–1(b)(2) and 1.1012–1(b). Refer to Chapter 5 for a discussion of this subject.

[13] See Chapter 4 for a discussion of bond discount and the related amortization.



Bridge to Financial Accounting

Certain property transactions discussed later in this chapter are treated differently for tax purposes than for financial accounting purposes. For example, the category of transactions generally referred to as "nontaxable exchanges," such as like-kind exchanges and involuntary conversions, gives taxpayers the opportunity to defer the recognition of income on the disposition of property in qualifying transactions. The gains or losses deferred under tax law, however, are not deferred for financial reporting purposes. Instead, the actual gain or loss realized is reflected in the entity's financial reports.

Identifying and calculating the book-tax differences that arise from *taxable* dispositions of certain other property may not be so easy. For example, as discussed in Chapter 5, cost recovery (i.e., depreciation) rules provided by the tax law specify various ways in which an asset's cost may be recovered over time. These methods often differ from the methods used to depreciate an asset for book purposes. Consequently, the annual book-tax differences in these depreciation expense calculations are noted in the financial reports. But, in addition, these cumulative differences, as reflected in the accumulated depreciation account, will also produce a book-tax difference on the asset's disposition. That is, because an asset's accumulated depreciation may differ for book and tax purposes, its adjusted basis will also differ. Consequently, when the asset is sold, the amount of gain or loss for book purposes will differ from that recognized for tax purposes.

Capital Recoveries

Capital recoveries decrease the adjusted basis of property. The following are examples of capital recoveries:

1. *Depreciation and cost recovery allowances.* The original basis of depreciable property is reduced by the annual depreciation charges (or cost recovery allowances) while the property is held by the taxpayer. The amount of depreciation that is subtracted from the original basis is the greater of the *allowed* or *allowable* depreciation calculated on an annual basis.[14] In most circumstances, the allowed and allowable depreciation amounts are the same (refer to Chapter 5).
2. *Casualties and thefts.* A casualty or theft may result in the reduction of the adjusted basis of property.[15] The adjusted basis is reduced by the amount of the deductible loss. In addition, the adjusted basis is reduced by the amount of insurance proceeds received. However, the receipt of insurance proceeds may result in a recognized gain rather than a deductible loss. The gain increases the adjusted basis of the property.[16]

EXAMPLE 5

An insured truck owned by the Falcon Corporation is destroyed in an accident. The adjusted basis is $8,000, and the fair market value is $6,500. Falcon received insurance proceeds of $6,500. The amount of the casualty loss is $1,500 ($6,500 insurance proceeds − $8,000 adjusted basis). The adjusted basis becomes $0 ($8,000 pre-accident adjusted basis, reduced by the $1,500 casualty loss and the $6,500 of insurance proceeds received). ■

EXAMPLE 6

Osprey, Inc., owned an insured truck that was destroyed in an accident. The adjusted basis and fair market value of the truck were $6,500 and $8,000, respectively. Osprey received insurance proceeds of $8,000. The amount of the casualty *gain* is $1,500 ($8,000 insurance proceeds − $6,500 adjusted basis). The adjusted basis is increased by the $1,500 casualty gain and is reduced by the $8,000 of insurance proceeds received ($6,500 basis before casualty + $1,500 casualty gain − $8,000 insurance proceeds = $0 basis). ■

[14] § 1016(a)(2) and Reg. § 1.1016–3(a)(1)(i).

[15] Refer to Chapter 6 for the discussion of casualties and thefts.

[16] Reg. § 1.1016–6(a).

3. *Certain corporate distributions.* A corporate distribution to a shareholder that is not taxable is treated as a return of capital, and it reduces the basis of the shareholder's stock in the corporation.[17] Once the basis of the stock is reduced to zero, the amount of any subsequent distributions is a capital gain if the stock is a capital asset. See Chapter 10.
4. *Amortizable bond premium.* The basis in a bond purchased at a premium is reduced by the amortizable portion of the bond premium.[18] Investors in taxable bonds may *elect* to amortize the bond premium.[19] The amount of the amortized premium on taxable bonds is permitted as an interest deduction. Therefore, the election enables the taxpayer to take an annual interest deduction to offset ordinary income in exchange for a larger capital gain or smaller capital loss on the disposition of the bond (due to the basis reduction).



In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

In contrast to the treatment of taxable bonds, the premium on tax-exempt bonds *must* be amortized, and no interest deduction is permitted. Furthermore, the basis of tax-exempt bonds is reduced even though the amortization is not allowed as a deduction. No amortization deduction is permitted on tax-exempt bonds because the interest income is exempt from tax, and the amortization of the bond premium merely represents an adjustment of the effective amount of such income.

EXAMPLE 7

Navy, Inc., purchases Eagle Corporation taxable bonds with a face value of $100,000 for $110,000, thus paying a premium of $10,000. The annual interest rate is 7%, and the bonds mature 10 years from the date of purchase. The annual interest income is $7,000 (7% × $100,000). If Navy elects to amortize the bond premium, the $10,000 premium is deducted over the 10-year period. Navy's basis for the bonds is reduced each year by the amount of the amortization deduction. If the bonds were tax-exempt, amortization of the bond premium and the basis adjustment would be mandatory, and no deduction would be allowed for the amortization. ■

5. *Easements.* An easement is the legal right to use another's land for a special purpose. Historically, easements were commonly used to obtain rights-of-way for utility lines and roads. In recent years, grants of conservation easements have become a popular means of obtaining charitable contribution deductions and reducing the value of real estate for transfer tax (i.e., estate and gift) purposes. Likewise, scenic easements are used to reduce the value of land as assessed for ad valorem property tax purposes.

   If the taxpayer does not retain any right to the use of the land, all of the basis is assigned to the easement. However, if the use of the land is only partially restricted, an allocation of some of the basis to the easement is appropriate.

LO.2

Distinguish between realized and recognized gain or loss.

RECOGNIZED GAIN OR LOSS

Recognized gain is the amount of the realized gain that is included in the taxpayer's gross income.[20] A **recognized loss**, on the other hand, is the amount of a realized loss that is deductible for tax purposes.[21] As a general rule, the entire amount of a realized gain or loss is recognized when it is realized.[22]

Concept Summary 7.1 summarizes the realized gain or loss and recognized gain or loss concepts.

[17] § 1016(a)(4) and Reg. § 1.1016–5(a).

[18] § 1016(a)(5) and Reg. § 1.1016–5(b). The accounting treatment of bond premium amortization is the same as for tax purposes. The amortization results in a decrease in the bond investment account.

[19] § 171(c).

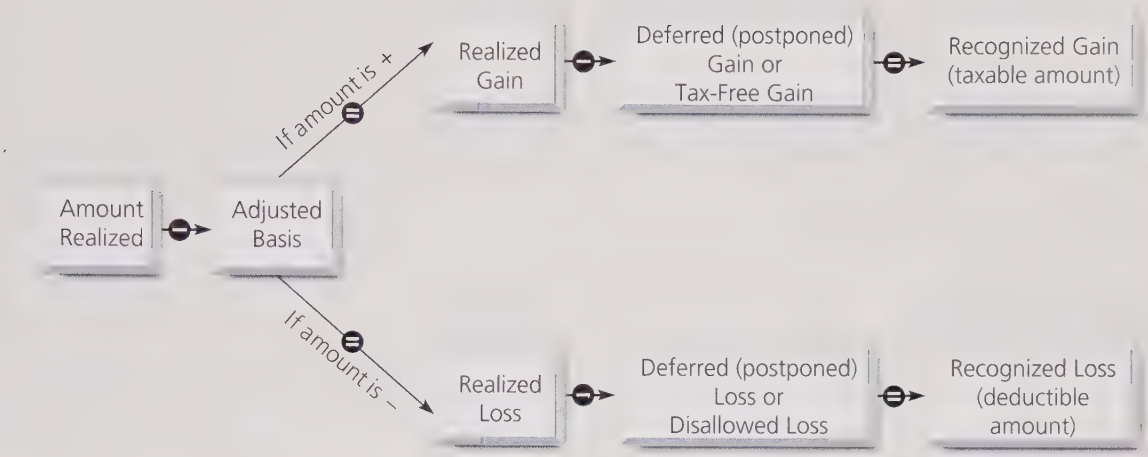
[20] § 61(a)(3) and Reg. § 1.61–6(a).

[21] § 165(a) and Reg. § 1.165–1(a).

[22] § 1001(c) and Reg. § 1.1002–1(a).

CONCEPT SUMMARY 7.1

Recognized Gain or Loss



NONRECOGNITION OF GAIN OR LOSS

In certain cases, a realized gain or loss is not recognized upon the sale or other disposition of property. One such case involves nontaxable exchanges, which are covered later in this chapter. In addition, realized losses from the sale or exchange of property between certain related parties are not recognized.[23]

Dispositions of Personal-Use Assets

For individual taxpayers, special rules apply to *personal-use* assets, that is, assets such as a residence or automobile that are not used in any business or investment activity. A loss from the sale, exchange, or condemnation of such assets is not recognized for tax purposes. An exception exists for casualty or theft losses from personal-use assets (refer to Chapter 6). In contrast, any gain realized from the disposition of personal-use assets is generally taxable.

Freda sells an automobile, which she has held exclusively for personal use, for $6,000. The adjusted basis of the automobile is $5,000. Freda has a realized and recognized gain of $1,000. If she sold this automobile for $4,500, she would have a realized loss of $500, but the loss would not be recognized for tax purposes. ■

RECOVERY OF CAPITAL DOCTRINE

Doctrine Defined

The **recovery of capital doctrine** pervades all the tax rules relating to property transactions. The doctrine derives its roots from the very essence of the income tax—a tax on income or profit. Because the focus of the tax is on profit, a taxpayer is entitled to recover the cost or other original basis of property acquired without being taxed on that amount.

The cost or other original basis of depreciable property is recovered through annual depreciation deductions. The basis is reduced as the cost is recovered over the period the property is held. Therefore, when property is sold or otherwise disposed of, it is the adjusted basis (unrecovered cost or other basis) that is compared with the amount realized from the disposition to determine realized gain or loss.

[23] § 267(a)(1).

TAX in the NEWS

TRIPLE THE MISERY!

Although short sales have traditionally involved stocks, today the term *short sale* also refers to the sale of a personal residence by a homeowner who is "underwater," owing more on the home than it is worth. In a short sale, the homeowner sells the residence for its fair market value, which is less than the mortgage (or mortgages) on the property. One possible result of this transaction is that the taxpayer incurs a realized loss—the selling price is less than his or her basis in the property. Unfortunately, the realized loss cannot be recognized because a residence is a personal use asset. To add to the trauma of losing the home in a nondeductible loss sale, the mortgage company may require the taxpayer to keep paying on the portion of the mortgage still outstanding (i.e., the amount of the mortgage in excess of the net sales price). Thus, the taxpayer has triple misery: no home, a nondeductible loss, and an outstanding debt to pay.

EXAMPLE 9

Cardinal Corporation purchased a machine for $20,000 four years ago and has deducted depreciation totaling $13,000 during those years. Since Cardinal has recovered $13,000 through depreciation, the adjusted basis of this machine is $7,000 ($20,000 − $13,000). If Cardinal sells this machine, it subtracts the $7,000 adjusted basis from the amount realized when determining whether it realized a gain or loss upon the disposition. ■

DIGGING DEEPER 2

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

7.2 BASIS CONSIDERATIONS

LO.3

Explain how basis is determined for various methods of asset acquisition.

DETERMINATION OF COST BASIS

As noted earlier, the basis of property is generally the property's cost. Cost is the amount paid for the property in cash or other property.[24] This general rule follows logically from the recovery of capital doctrine; that is, the cost or other basis of property is to be recovered tax-free by the taxpayer.

A *bargain purchase* of property is an exception to the general rule for determining basis. A bargain purchase may result when an employer transfers property to an employee at less than the property's fair market value (as compensation for services) or when a corporation transfers property to a shareholder at less than the property's fair market value (a dividend). These transfers create taxable income for the purchaser equal to the difference between fair market value and purchase price. The basis of property acquired in a bargain purchase is the property's fair market value.[25] If the basis of the property were not increased by the bargain amount, the taxpayer would be taxed on this amount again at disposition.

EXAMPLE 10

Wade buys land from his employer for $10,000. The fair market value of the land is $15,000. Wade must include the $5,000 difference between the cost and the fair market value of the land in his gross income. The bargain element represents additional compensation to Wade. His basis for the land is $15,000, the land's fair market value. ■

[24] § 1012 and Reg. § 1.1012–1(a).

[25] Reg. §§ 1.61–2(d)(2)(i) and 1.301–1(j). See the discussion in Chapter 17 of the circumstances under which what appears to be a taxable bargain purchase is an excludible qualified employee discount.

TAX in the NEWS

Brokers to Provide Cost Basis Data

Recently enacted tax legislation requires brokers and others in similar enterprises to provide investors with an annual report on the cost basis of their stocks (to be included on Form 1099–B). Recognizing that many brokerage firms will have to modify their records in order to comply, Congress delayed implementation of the reporting requirement. It applies only to stock that customers buy on or after January 1, 2011.

The primary reason for the requirement is to enable taxpayers to use the correct basis in calculating the gain or loss on the sale of the stock. In the simplest situation in which only a single lot of the stock was purchased, the taxpayer still may not have this information available when the stock is sold—perhaps many years later. Even if the investor maintains good records, nontaxable stock dividends, stock splits, and spin-offs may create confusion and result in unreliable data being used to determine the basis. For the investor who has multiple purchases of a stock, the likelihood of making an incorrect determination of cost basis is even greater.

A secondary reason for the reporting requirement is to generate more revenue for the Treasury. The government believes that taxpayers are knowingly underreporting capital gains on the sale of securities. It anticipates that it will collect billions of dollars over the next 10 years by requiring this broker reporting.

Source: Adapted from Arden Dale, "Investors to Get Reports on Cost Basis of Stocks," *Wall Street Journal*, February 5, 2009, p. D4.

Identification Problems

Sometimes, it can be difficult to determine the cost of an asset being sold. This problem is frequently encountered in sales of corporate stock, because a taxpayer may purchase separate lots of a company's stock on different dates and at different prices. When the stock is sold, if the taxpayer cannot identify the specific shares being sold, the stock sold is determined on a first-in, first-out (FIFO) basis. Thus, the holding period and cost of the stock sold are determined by referring to the purchase date and cost of the first lot of stock acquired.[26] But if the stock being sold can be adequately identified, then the basis and holding period of the specific stock sold are used in determining the nature and amount of gain or loss.[27] Thus, to avoid FIFO treatment when the sold securities are held by a broker, it is often necessary to provide specific instructions and receive written confirmation of the securities being sold.

EXAMPLE 11

Pelican, Inc., purchases 100 shares of Olive Corporation stock on July 1, 2008, for $5,000 ($50 a share) and another 100 shares of Olive stock on July 1, 2009, for $6,000 ($60 a share). Pelican sells 50 shares of the stock on January 2, 2010. The cost of the stock sold, assuming Pelican cannot adequately identify the shares, is $50 a share (from shares purchased on July 1, 2008), or $2,500. This is the cost Pelican will compare with the amount realized in determining the gain or loss from the sale. ■

Allocation Problems

When a taxpayer acquires *several assets in a lump-sum purchase,* the total cost must be allocated among the individual assets.[28] Allocation is necessary for several reasons:

- Some of the assets acquired may be depreciable (e.g., buildings), while others may not be (e.g., land).
- Only a portion of the assets acquired may be sold.
- Some of the assets may be capital or depreciable assets that receive special tax treatment upon subsequent sale or other disposition.

The lump-sum cost is allocated on the basis of the fair market values of the individual assets acquired.

[26] *Kluger Associates, Inc.*, 69 T.C. 925 (1978).
[27] Reg. § 1.1012–1(c)(1).
[28] Reg. § 1.61–6(a).

EXAMPLE 28

Magenta Corporation purchases a building and land for $800,000. Because of the depressed nature of the industry in which the seller was operating, Magenta was able to negotiate a very favorable purchase price. Appraisals of the individual assets indicate that the fair market value of the building is $600,000 and that of the land is $400,000. Magenta's basis for the building is $480,000 [($600,000/$1,000,000) × $800,000], and its basis for the land is $320,000 [($400,000/$1,000,000) × $800,000]. ■

If a business is purchased and **goodwill** is involved, a special allocation applies. Initially, the purchase price is assigned to the assets, excluding goodwill, to the extent of their total fair market value. This assigned amount is allocated among the assets on the basis of the fair market value of the individual assets acquired. Goodwill is then assigned the residual amount of the purchase price. The resultant allocation is applicable to both the buyer and the seller.[29]

EXAMPLE 29

Roadrunner, Inc., sells its business to Coyote Corporation. The two companies agree that the values of the specific assets are as follows:

Cash	$ 10,000
Marketable securities	5,000
Inventory	35,000
Building	500,000
Land	200,000

After negotiations, Roadrunner and Coyote agree on a sales price of $1 million. Applying the residual method, the residual purchase price is allocated to goodwill, resulting in the following basis of assets to Coyote Corporation:

Cash	$ 10,000
Marketable securities	5,000
Inventory	35,000
Building	500,000
Land	200,000
Goodwill	250,000

■

In the case of *nontaxable stock dividends*, the allocation depends on whether the dividend is a common stock dividend on common stock or a preferred stock dividend on common stock. If the dividend is common on common, the cost of the original common shares is allocated to the total shares owned after the dividend.[30]

EXAMPLE 30

Yellow, Inc., owns 100 shares of Sparrow Corporation common stock for which it paid $1,100. Yellow receives a 10% common stock dividend, giving it a new total of 110 shares. Before the stock dividend, Yellow's basis was $11 per share ($1,100 ÷ 100 shares). The basis of each share after the stock dividend is $10 ($1,100 ÷ 110 shares). ■

If the nontaxable stock dividend is preferred stock on common, the cost of the original common shares is allocated between the common and preferred shares on the basis of their relative fair market values on the date of distribution.[31]

EXAMPLE 31

Brown Company owns 100 shares of Cardinal Corporation common stock for which it paid $1,000. Brown receives a nontaxable stock dividend of 50 shares of preferred stock on the Cardinal common stock. The fair market values on the date of distribution of the preferred stock dividend are $30 a share for common stock and $40 a share for preferred stock.

[29] § 1060.

[30] §§ 305(a) and 307(a). The holding period of the new shares includes the holding period of the old shares. § 1223(5) and Reg. § 1.1223–1(e). See Chapter 8 for a discussion of the importance of the holding period.

[31] Reg. § 1.307–1(a).

Fair market value of common ($30 × 100 shares)	$3,000
Fair market value of preferred ($40 × 50 shares)	2,000
	$5,000
Basis of common: 3/5 × $1,000	$ 600
Basis of preferred: 2/5 × $1,000	$ 400

The basis per share for the common stock is $6 ($600/100 shares). The basis per share for the preferred stock is $8 ($400/50 shares). ■

GIFT BASIS

Although business entities can neither make nor receive gratuitous transfers, ownership interests in such entities are frequently the subject of lifetime and testamentary gifts. Partnership interests, stock in closely or publicly held corporations, and other assets are regularly passed from one generation of owners to another for a variety of family and business reasons. Special basis rules apply to such transfers.

When a taxpayer receives property as a gift, there is no cost to the donee (recipient). Thus, under the cost basis provision, the donee's basis would be zero. With a zero basis, if the donee sold the property, the entire amount realized would be treated as taxable gain. Instead, the Code[32] assigns a basis to the property received that depends upon the following:

- The date of the gift.
- The basis of the property to the donor.
- The fair market value of the property.
- The amount of the gift tax paid, if any.

Gift Basis Rules If No Gift Tax Is Paid

If a property's fair market value on the date of the gift exceeds the donor's basis in the property, the donor's basis carries over to the new owner.[33] This basis is called a *carryover basis* and is used in determining the donee's gain or loss.

EXAMPLE 20

Melissa purchased stock two years ago for $10,000. She gave the stock to her son, Joe, this year, when the fair market value was $15,000. No gift tax was paid on the transfer. Joe subsequently sells the property for $15,000. Joe's basis is $10,000, and he has a realized gain of $5,000. ■

If the property's fair market value on the date of the gift is *lower* than the donor's basis in the property, the donee's basis cannot be determined until the donee disposes of the property. For the purpose of determining *gain*, the donor's basis will carry over, as in the preceding example. But for determining *loss*, the property's basis will be its fair market value when the gift was made.

EXAMPLE 21

Burt purchased stock three years ago for $10,000. He gave the stock to his son, Cliff, this year, when the fair market value was $7,000. No gift tax was paid on the transfer. Cliff later sells the stock for $6,000. For determining loss, Cliff's basis is $7,000, and the realized loss from the sale is $1,000 ($6,000 amount realized − $7,000 basis). ■

Note that this loss basis rule prevents the donee from receiving a tax benefit from a decline in value that occurred while the donor held the property. Therefore, in the preceding example, Cliff has a loss of only $1,000 rather than a loss of $4,000. The $3,000 difference represents the decline in value that occurred while Burt held the property.

[32] § 1015(a).

[33] § 1015(a) and Reg. § 1.1015–1(a)(1). See Reg. § 1.1015–1(a)(3) for cases in which the facts necessary to determine the donor's adjusted basis are unknown. See Example 22 for the effect of depreciation deductions by the donee.

Ironically, however, a donee might be subject to income tax on the appreciation that occurred while the donor held the property, as illustrated in Example 16.

In any case, the operation of this dual basis rule produces a curious anomaly: if the sales proceeds fall *between* the donor's adjusted basis and the property's fair market value at the date of gift, no gain or loss is recognized.

EXAMPLE 16

Assume the same facts as in the preceding example, except that Cliff sells the stock for $8,000. To calculate gain, he would use a basis of $10,000, the donor's adjusted basis. But when a $10,000 basis is compared to $8,000 of sales proceeds, a *loss* is produced. Yet in determining loss, Cliff must use the property's fair market value at the date of gift—namely, $7,000. When a $7,000 basis is compared to sales proceeds of $8,000, a *gain* is produced. Accordingly, no gain or loss is recognized on this transaction. ■

Tax Planning Strategies GIFT PLANNING

FRAMEWORK FOCUS: TAX RATE

Strategy: Shift Net Income from High-Bracket Taxpayers to Low-Bracket Taxpayers.

FRAMEWORK FOCUS: DEDUCTIONS

Strategy: Maximize Deductible Amounts.

Gifts of *appreciated property* can produce tax savings if the donee is in a lower tax bracket than the donor. The carryover basis rule effectively shifts the tax on the property's appreciation to the new owner, even if all of the appreciation arose while the property was owned by the donor.

On the other hand, donors should generally avoid making gifts of property that is worth less than the donor's adjusted basis (loss property). The operation of the basis rule for losses may result in either (1) a realized loss that is not deductible by either the donor or the donee or (2) reduced tax benefits when the loss is recognized by a donee facing lower marginal tax rates. Unless the property is expected to rebound in value before it is sold, a donor would be better advised to sell the property that has declined in value, deduct the resulting loss, and then transfer the proceeds to the prospective donee.

Adjustment for Gift Tax

If gift taxes are paid by the donor, the donee's basis may exceed the donor's basis. This occurs only if the fair market value of the property at the date of the gift exceeds the donor's adjusted basis (i.e., the property has appreciated in value). The portion of the gift tax paid that is related to the appreciation is added to the donor's basis in calculating the donee's basis for the property. In this circumstance, the following formula is used for calculating the donee's basis:[34]

$$\text{Donee's basis} = \text{Donor's adjusted basis} + \left(\frac{\text{Unrealized appreciation}}{\text{Taxable gift*}} \times \text{Gift tax paid}\right)$$

*The taxable gift is the fair market value of the gift less the per donee annual exclusion

EXAMPLE 17

In 2010, Bonnie made a gift of stock (adjusted basis of $15,000) to Peggy earlier this year. The stock had a fair market value of $50,000, and the transfer resulted in a gift tax of $4,000.

[34] § 1015(d)(6) and Reg. § 1.1015–5(c)(2).

The unrealized appreciation of the stock is $35,000 ($50,000 fair market value − $15,000 adjusted basis), and the taxable gift is $37,000 ($50,000 fair market value of gift − $13,000 per donee annual exclusion). Peggy's basis in the stock is $18,800, determined as follows:

Donor's adjusted basis	$15,000
Gift tax attributable to appreciation—	
$35,000/$37,000 = 95% (rounded) × $4,000	3,800
Donee's gain basis	$18,800

■

Don made a gift of stock to Matt earlier this year, when the fair market value of the stock was $50,000. Don paid gift tax of $4,000. Don had purchased the stock 10 years ago for $65,000. Because there is no unrealized appreciation at the date of the gift, none of the gift tax paid is added to Don's basis in calculating Matt's basis. Thus, Matt's gain basis is $65,000. ■

For *gifts made before 1977*, the full amount of the gift tax paid is added to the donor's basis. However, the ceiling on this total is the fair market value of the property at the date of the gift. Thus, in Example 19, if the gift had been made before 1977, the basis of the property would be $19,000 ($15,000 + $4,000). In Example 20, the donee's basis would still be $65,000 ($65,000 + $0) for gain and $50,000 for loss.

Holding Period

The **holding period** for property acquired by gift begins on the date the donor acquired the property,[35] unless the special circumstance requiring use of the property's fair market value at the date of gift applies. If so, the holding period starts on the date of the gift.[36] The significance of the holding period for capital assets is discussed in Chapter 8.

The following example summarizes the basis and holding period rules for gift property.

Jill acquired 100 shares of Wren Corporation stock on December 30, 2007, for $40,000. On January 3 of this year, when the stock has a fair market value of $38,000, Jill gives it to Dennis and pays gift tax of $4,000. The basis is not increased by a portion of the gift tax paid because the property has not appreciated in value at the time of the gift. Therefore, Dennis's basis for determining gain is $40,000. Dennis's basis for determining loss is $38,000 (fair market value), because the fair market value on the date of the gift is less than the donor's adjusted basis.

- If Dennis sells the stock for $45,000, he has a recognized gain of $5,000. The holding period for determining whether the capital gain is short term or long term begins on December 30, 2007, the date Jill acquired the property.
- If Dennis sells the stock for $36,000, he has a recognized loss of $2,000. The holding period for determining whether the capital loss is short term or long term begins on January 3 of this year, the date of the gift.
- If Dennis sells the property for $39,000, no gain or loss is recognized because the amount realized is between the property's fair market value when given ($38,000) and the donor's adjusted basis of $40,000. ■

Basis for Depreciation

The basis for depreciation on depreciable gift property is the donee's basis for determining gain.[37] This rule is applicable even if the donee later sells the property at a loss and uses the property's fair market value at the date of gift in calculating the amount of the realized loss.

Vito gave a machine to Tina earlier this year. At that time, the adjusted basis was $32,000 (cost of $40,000 − accumulated depreciation of $8,000), and the fair market

[35] § 1223(2) and Reg. § 1.1223–1(b).
[36] Rev.Rul. 59–86, 1959–1 C.B. 209.
[37] § 1011 and Reg. §§ 1.1011–1 and 1.167(g)–1.

value was $26,000. No gift tax was due. Tina's basis for determining gain is $32,000, and her loss basis is $26,000. During this year, Tina deducts depreciation (cost recovery) of $6,400 ($32,000 × 20%). (Refer to Chapter 5 for the cost recovery tables.) At the end of this year, Tina's basis determinations are calculated as follows:

	Gain Basis	Loss Basis
Donor's basis or fair market value	$32,000	$26,000
Depreciation	(6,400)	(6,400)
	$25,600	$19,600

■

PROPERTY ACQUIRED FROM A DECEDENT

General Rules

The basis of property acquired from a decedent is generally the property's fair market value at the date of death (referred to as the *primary valuation amount*).[38] The property's basis is the fair market value six months after the date of death if the executor or administrator of the estate *elects* the alternate valuation date for estate tax purposes. This amount is referred to as the *alternate valuation amount.*



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EXAMPLE 24

Linda and various other family members inherited stock in a closely held corporation from Linda's father, who died earlier this year. At the date of death, her father's adjusted basis for the stock Linda inherited was $35,000. The stock's fair market value at the date of death was $50,000. The alternate valuation date was not elected. Linda's basis for income tax purposes is $50,000. This is commonly referred to as a *stepped-up basis.* ■

EXAMPLE 25

Assume the same facts as in the preceding example, except that the stock's fair market value at the date of death was $20,000. Linda's basis for income tax purposes is $20,000. This is commonly referred to as a *stepped-down basis.* ■

No estate tax return must be filed for estates below a threshold amount (refer to Chapter 1). In such cases, the alternate valuation date and amount are not available. Even if an estate tax return is filed and the executor elects the alternate valuation date, the six-months-after-death date is available only for property that the executor has not distributed before this date. For any property distributed or otherwise disposed of by the executor during the six-month period preceding the alternate valuation date, the adjusted basis to the beneficiary will equal the fair market value on the date of distribution or other disposition.[39]

The alternate valuation date can be elected *only if*, as a result of the election, *both* the value of the gross estate and the estate tax liability are lower than they would have been if the primary valuation date had been used. This provision prevents the alternate valuation election from being used to increase the basis of the property to the beneficiary for income tax purposes without simultaneously increasing the estate tax liability (because of estate tax deductions or credits).[40]

[38] § 1014(a). At the time of this writing, Congress has not yet reenacted the estate tax nor rescinded the new carryover basis rules of Sec. 1022. However, as both are expected to occur, our Examples and Problem Materials assume that the fair market value basis rules will continue to apply to property inherited after 2009.

[39] § 2032(a)(1) and Rev.Rul. 56–60, 1956–1 C.B. 443.

[40] § 2032(c).

Nancy inherited investment real estate from her father, who died earlier this year. Her father's adjusted basis for the property at the date of death was $650,000. The property's fair market value was $4,750,000 at the date of death and $4,760,000 six months after death. The alternate valuation date cannot be elected because the value of the gross estate has increased during the six-month period. Nancy's basis for income tax purposes is $4,750,000. ■

Assume the same facts as in Example 25, except that the property's fair market value six months after death was $4,745,000. If the executor elects the alternate valuation date, Nancy's basis for income tax purposes is $4,745,000. ■

Assume the same facts as in Example 26, except that the property is distributed four months after the date of the decedent's death. At the distribution date, the property's fair market value is $4,747,500. Since the executor elected the alternate valuation date, Nancy's basis for income tax purposes is $4,747,500. ■

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.



Tax Planning Strategies PROPERTY FROM A DECEDENT

FRAMEWORK FOCUS: INCOME

Strategy: Avoid Income Recognition.

FRAMEWORK FOCUS: DEDUCTIONS

Strategy: Maximize Deductible Amounts.

If a taxpayer *retains appreciated property* until death, the property's basis will be "stepped up" to its fair market value at that time. Thus, no income tax will be paid on the property's appreciation by either the former owner (the decedent) or the new owner (the heir).

On the other hand, *depreciated property should be sold* prior to death. Otherwise, the property's basis in the heir's hands will be its declined fair market value, and neither the decedent nor the heir will be able to deduct the loss that occurred while the property was owned by the decedent.

Deathbed Gifts

The Code contains a provision designed to eliminate a tax avoidance technique occasionally described as *deathbed gifts*. With this technique, a donor makes a gift of appreciated property to a dying person with the understanding that the donor (or the donor's spouse) will inherit the property on the donee's death. If a person (or that person's spouse) receives from a decedent property that this person gave to the decedent during the year before the decedent's death, the property does *not* get a stepped-up basis. Instead, the basis of that property is the donor's adjusted basis.[41]

Ned gives stock to his uncle, Vern, this year. Ned's basis for the stock is $100,000, and the fair market value is $900,000. No gift tax is due. Eight months later, Ned inherits the stock from Vern. At the date of Vern's death, the fair market value of the stock is $980,000. Ned's adjusted basis for the stock is $100,000. ■

[41] § 1014(e).

Holding Period of Property Acquired from a Decedent

The holding period of property acquired from a decedent is *deemed to be long term* (held for the required long-term holding period). This provision applies regardless of whether the property is disposed of at a gain or at a loss.[42]

LO.4

Describe various loss disallowance provisions.

DISALLOWED LOSSES

Related Taxpayers

Section 267 provides that realized losses from sales or exchanges of property between certain related parties are not recognized. This loss disallowance provision applies to several types of related-party transactions. The most common involve (1) members of a family and (2) an individual and a corporation in which the individual owns, directly or indirectly, more than 50 percent in value of the corporation's outstanding stock. Section 707 provides a similar loss disallowance provision where the related parties are a partner and a partnership in which the partner owns, directly or indirectly, more than 50 percent of the capital interests or profits interests in the partnership. Neither provision, however, prevents the recognition of *gains* between related parties. The rules governing the relationships covered by § 267 were discussed in Chapter 5.

If income-producing or business property is transferred to a related party and a loss is disallowed, the basis of the property to the recipient is the property's cost to the transferee. However, if a subsequent sale or other disposition of the property by the original transferee results in a realized gain, the amount of gain is reduced by the loss that was previously disallowed. This *right of offset* is not applicable if the original sale involved the sale of a personal-use asset (e.g., a personal residence). Furthermore, the right of offset is available only to the original transferee (the related-party buyer). See Example 17 and Example 18 in Chapter 5.



In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

Wash Sales

Section 1091 stipulates that in certain cases, a realized loss on the sale or exchange of stock or securities is not recognized. Specifically, if a taxpayer sells or exchanges stock or securities and within 30 days before *or* after the date of the sale or exchange acquires *substantially identical* stock or securities, any loss realized from the sale or exchange is not recognized because the transaction is a **wash sale**.[43] The term *acquire* means acquire by purchase or in a taxable exchange and includes an option to purchase substantially identical securities. *Substantially identical* means the same in all important particulars. Corporate bonds and preferred stock normally are not considered substantially identical to a corporation's common stock. However, if the bonds and preferred stock are convertible into common stock, they may be considered substantially identical under certain circumstances.[44] Attempts to avoid the application of the wash sale rules by having a related taxpayer repurchase the securities have been unsuccessful.[45] The wash sale provisions do *not* apply to gains.

Recognition of the loss is disallowed because the taxpayer is considered to be in substantially the same economic position after the sale and repurchase as before. This disallowance rule does not apply to taxpayers engaged in the business of buying and selling securities.[46] Investors, however, are not allowed to create losses through wash sales to offset income for tax purposes.

[42] § 1223(11).
[43] § 1091(a) and Reg. §§ 1.1091–1(a) and (f).
[44] Rev.Rul. 56–406, 1956–2 C.B. 523.
[45] *McWilliams v. Comm.*, 47–1 USTC ¶9289, 35 AFTR 1184, 67 S.Ct. 1477 (USSC, 1947).
[46] Reg. § 1.1091–1(a).

A realized loss that is not recognized is added to the *basis* of the substantially identical stock or securities whose acquisition resulted in the nonrecognition of loss.[47] In other words, the basis of the replacement stock or securities is increased by the amount of the unrecognized loss. If the loss were not added to the basis of the newly acquired stock or securities, the taxpayer would never recover the entire basis of the old stock or securities. As a result, the wash sale rule operates to *defer* the recognition of the taxpayer's loss.

EXAMPLE 24

Oriole Manufacturing Company sold 50 shares of Green Corporation stock (adjusted basis of $10,000) for $8,000. Ten days later, Oriole purchased 50 shares of the same stock for $7,000. Oriole's realized loss of $2,000 ($8,000 amount realized − $10,000 adjusted basis) is not recognized because it resulted from a wash sale. Oriole's basis in the newly acquired stock is $9,000 ($7,000 purchase price + $2,000 unrecognized loss from the wash sale). ■

The basis of the new stock or securities includes the unrecovered portion of the basis of the formerly held stock or securities. Therefore, the *holding period* of the new stock or securities begins on the date of acquisition of the old stock or securities.[48]

A taxpayer may acquire fewer shares than the number sold in a wash sale. In this case, the loss from the sale is prorated between recognized and unrecognized loss on the basis of the ratio of the number of shares acquired to the number of shares sold.[49]

Tax Planning Strategies AVOIDING WASH SALES

FRAMEWORK FOCUS: DEDUCTIONS

Strategy: Maximize Deductible Amounts.

The wash sale restriction can be avoided by replacing the sold security with a *similar* but not "substantially identical" security. For example, if IBM common stock is sold to claim an unrealized loss, the taxpayer could immediately acquire Intel common stock without triggering the wash sale rule.

Nontax considerations must also come into play, however, because IBM and Intel are two different companies with different investment prospects. Though both securities will be affected by many of the same factors, they will also be subject to different factors that may be even more significant than the ones they share.

CONVERSION OF PROPERTY FROM PERSONAL USE TO BUSINESS OR INCOME-PRODUCING USE

As discussed previously, losses from the sale of personal-use assets are not recognized for tax purposes, but losses from the sale of business and income-producing assets are deductible. Can a taxpayer convert a personal-use asset that has declined in value to business or income-producing use and then sell the asset to recognize a business or income-producing loss? The tax law prevents this practice by specifying that the *basis for determining loss* on personal-use assets converted to business or income-producing use is the *lower* of the property's adjusted basis or its fair market value on the date of conversion.[50] The *gain basis* for converted property is the property's adjusted basis on the date of conversion, regardless of whether the property's use is business, income-producing, or personal in nature.

[47] § 1091(d) and Reg. § 1.1091–2(a).
[48] § 1223(4) and Reg. § 1.1223–1(d).
[49] § 1091(b) and Reg. § 1.1091–1(c).
[50] Reg. § 1.165–9(b)(2).

EXAMPLE 30

Diane's personal residence has an adjusted basis of $175,000 and a fair market value of $160,000. When she converts the personal residence to residential rental property on January 1, her basis for determining loss is $160,000 (lower of $175,000 adjusted basis and fair market value of $160,000). The $15,000 decline in value is a personal loss and can never be recognized for tax purposes. Diane's basis for determining gain is $175,000. ■

The basis for determining loss is also the *basis for depreciating* the converted property.[51] This is an exception to the general rule that the basis for depreciation is the basis for determining gain (e.g., property received by gift). This exception prevents the taxpayer from recovering a personal loss indirectly through depreciation of the higher original basis. Once property is converted, both its basis for loss and its basis for gain are adjusted for depreciation deductions from the date of conversion to the date of disposition.

EXAMPLE 31

Assume the same facts as in Example 30. The MACRS cost recovery deduction for the current year is $5,576 ($160,000 × 3.485%). Thus, at the end of the current year, Diane's adjusted basis for gain for the rental property is $169,424 ($175,000 − $5,576), and her adjusted basis for loss is $154,424 ($160,000 − $5,576). ■



In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

SUMMARY OF BASIS ADJUSTMENTS

Some of the more common items that either increase or decrease the basis of an asset appear in Concept Summary 7.2.

In discussing the topic of basis, a number of specific techniques for determining basis have been presented. Although the various techniques are responsive to and mandated by transactions occurring in the marketplace, they possess enough common characteristics to be categorized as follows:

- The basis of the asset may be determined by its cost.
- The basis of the asset may be determined by the basis of another asset.
- The basis of the asset may be determined by its fair market value.
- The basis of the asset may be determined by the basis of the asset in the hands of another taxpayer.

7.3 General Concept of a Nontaxable Exchange

A taxpayer who is going to replace a productive asset (e.g., machinery) used in a trade or business may structure the transaction as a sale of the old asset and the purchase of a new asset. When this approach is used, any realized gain or loss on the sale of the old asset is recognized. The basis of the new asset is its cost. Alternatively, the taxpayer may be able to trade the old asset for the new asset. This exchange of assets may produce beneficial tax consequences as a nontaxable exchange.

The tax law recognizes that nontaxable exchanges result in a change in the *form* but not the *substance* of a taxpayer's relative economic position. The replacement property received in the exchange is viewed as essentially a continuation of the old investment.[52]

[51] Reg. § 1.167(g)–1.

[52] Reg. § 1.1002–1(c).



CONCEPT SUMMARY 7.2

Adjustments to Basis

Item	Effect	Refer to Chapter	Explanation
Amortization of bond discount.	Increase	7	Amortization is mandatory for certain taxable bonds and elective for tax-exempt bonds.
Amortization of bond premium.	Decrease	7	Amortization is mandatory for tax-exempt bonds and elective for taxable bonds.
Amortization of covenant not to compete.	Decrease	5	Covenant must be for a definite and limited time period. The amortization period is a statutory period of 15 years.
Amortization of intangibles.	Decrease	5	Intangibles are amortized over a 15-year period.
Bad debts.	Decrease	6	Most taxpayers must use the specific charge-off method.
Capital additions.	Increase	7	Certain items, at the taxpayer's election, can be capitalized or deducted.
Casualty.	Decrease	7	For a casualty loss, the amount of the adjustment is the sum of the deductible loss and the insurance proceeds received. For a casualty gain, the amount of the adjustment is the insurance proceeds received reduced by the recognized gain.
Condemnation.	Decrease	7	See casualty explanation.
Cost recovery.	Decrease	5	Section 168 is applicable to tangible assets placed in service after 1980 whose useful life is expressed in terms of years.
Depletion.	Decrease	5	Use the greater of cost or percentage depletion. Percentage depletion can be deducted even when the basis is zero.
Depreciation.	Decrease	5	Section 167 is applicable to tangible assets placed in service before 1981 and to tangible assets not depreciated in terms of years.
Easement.	Decrease	7	If the taxpayer does not retain any use of the land, all of the basis is allocable to the easement transaction. However, if only part of the land is affected by the easement, only part of the basis is allocable to the easement transaction.
Improvements by lessee to lessor's property.	Increase	4	Adjustment occurs only if the lessor is required to include the fair market value of the improvements in gross income under § 109.
Imputed interest.	Decrease		Amount deducted is not part of the cost of the asset.
Inventory: lower of cost or market.	Decrease		Not available if the LIFO method is used.
Limited expensing under § 179.	Decrease	5	Occurs only if the taxpayer elects § 179 treatment.
Medical capital expenditure deducted as a medical expense.	Decrease	16	Adjustment is the amount of the deduction (the effect on basis is to increase it by the amount of the capital expenditure net of the deduction).
Real estate taxes: apportionment between the buyer and seller.	Increase or decrease	5	To the extent the buyer pays the seller's pro rata share, the buyer's basis is increased. To the extent the seller pays the buyer's pro rata share, the buyer's basis is decreased.
Rebate from manufacturer.	Decrease		Since the rebate is treated as an adjustment to the purchase price, it is not included in the buyer's gross income.
Stock dividend.	Decrease	7	Adjustment occurs only if the stock dividend is nontaxable. While the basis per share decreases, the total stock basis does not change.
Stock rights.	Decrease	10	Adjustment to stock basis occurs only for nontaxable stock rights and only if the fair market value of the rights is at least 15% of the fair market value of the stock or, if less than 15%, the taxpayer elects to allocate the basis between the stock and the rights.
Theft.	Decrease	6	See casualty explanation.

Additional justification for nontaxable treatment is that this type of transaction does not provide the taxpayer with the wherewithal to pay the tax on any realized gain.

The nonrecognition provisions for nontaxable exchanges do not apply to realized losses from the sale or exchange of personal-use assets. Such losses are never recognized (i.e., they are disallowed) because they are personal in nature.

In contrast, in a **nontaxable exchange**, recognition of gains or losses is *postponed* (i.e., deferred) until the new property received in the nontaxable exchange is subsequently disposed of in a taxable transaction. This is accomplished by assigning a carryover basis to the replacement property.

EXAMPLE 32

Starling Management Company exchanges property with an adjusted basis of $10,000 and a fair market value of $12,000 for property with a fair market value of $12,000. The transaction qualifies for nontaxable exchange treatment. Starling has a realized gain of $2,000 ($12,000 amount realized − $10,000 adjusted basis). Its recognized gain is $0. Starling's basis in the replacement property is a carryover basis of $10,000. Assume the replacement property is nondepreciable and Starling subsequently sells it for $12,000. The realized and recognized gain will be the $2,000 gain that was postponed (deferred) in the nontaxable transaction. If the replacement property is depreciable, the carryover basis of $10,000 is used in calculating depreciation. ■

In some nontaxable exchanges, only some of the property involved in the transaction qualifies for nonrecognition treatment. If the taxpayer receives cash or other nonqualifying property, part or all of the realized gain from the exchange is recognized. In these situations, gain is recognized because the taxpayer has changed or improved its relative economic position and has the wherewithal to pay income tax to the extent of cash or other property received.

It is important to distinguish between a nontaxable disposition (or nonrecognition transaction, as the term is used in the statute) and a tax-free transaction. As previously mentioned, the term *nontaxable* refers to postponement of recognition via some version of carryover basis. In a *tax-free* transaction, the nonrecognition is permanent (e.g., see the discussion later in this chapter of the exclusion of gain from the sale of a principal residence).

Either way, nontaxable and tax-free transactions must be understood as exceptions to the Code's general rule that gains and losses are recognized when they are realized. These exceptions have their own sets of requirements, limitations, and restrictions, all of which must be satisfied for a transaction to be characterized as nontaxable or tax-free. Otherwise, the general rule of recognition applies to the gain or loss at hand.

7.4 Like-Kind Exchanges—§ 1031

LO.5

Apply the nonrecognition provisions and basis determination rules for like-kind exchanges.

Section 1031 provides for nontaxable exchange treatment if the following requirements are satisfied:[53]

- The form of the transaction is an exchange.
- Both the property transferred and the property received are held either for productive use in a trade or business or for investment.
- The property is like-kind property.

Qualifying **like-kind exchanges** include exchanges of business for business, business for investment, investment for business, or investment for investment property. Property held for personal use does not qualify under the like-kind exchange provisions. Thus, the purpose for which the property is held by the taxpayer in question is critical. For example, if Janet uses a small truck in her trade or business, it may

[53] § 1031(a) and Reg. § 1.1031(a)–1(a).

TAX

Classic Tax Planning Strategy Ignored

In the present economic environment, taxpayers may be wise to consider *avoiding* the like-kind exchange rules. For example, in certain situations the beneficial result of tax deferral of realized gain could be more than offset by future tax rate increases. Some real estate investors are following this approach, particularly with respect to undeveloped land. They are willing to accept current taxation at 15 percent to avoid the possibility of future taxation at a much higher rate. Many believe that the capital gains tax rate could rise to 20 or 25 percent in the near future. Although turning down a tax deferral may sound like a strange strategy, it fits the notion of "pay a tax today to avoid a higher tax tomorrow."

qualify for like-kind treatment, but if she uses this truck as her personal-use vehicle, it is ineligible for nonrecognition treatment under § 1031.

Some assets are excluded from like-kind treatment by statute. These excluded assets include a taxpayer's inventory or "stock in trade," as well as most forms of investment other than real estate. Thus, stocks, bonds, partnership interests (whether general or limited), and other securities, even though held for investment, do not qualify for like-kind exchange treatment.

The nonrecognition provision for like-kind exchanges is *mandatory* rather than elective. A taxpayer who wants to recognize a realized gain or loss will have to structure the transaction in a form that does not satisfy the statutory requirements for a like-kind exchange.

Tax Planning Strategies **Like-Kind Exchanges**

FRAMEWORK FOCUS: DEDUCTIONS

Strategy: Maximize Deductible Amounts.

Because nonrecognition of gain or loss is mandatory in like-kind exchanges, a taxpayer must affirmatively *avoid such exchanges* if nonrecognition treatment is not desired. If an asset is worth less than its adjusted basis, a *loss would result* from its disposition. Accordingly, the taxpayer should sell this property outright to ensure the deductibility of the loss, assuming it would otherwise be deductible.

Even if *disposition would result in a gain*, a taxpayer might want to recognize this gain in the current taxable year. If so, a like-kind exchange should be avoided. Circumstances suggesting this strategy include:

- Unused capital loss carryovers, especially if the taxpayer is a corporation for which such carryovers are limited in duration (see Chapters 4 and 8).
- Unused net operating loss carryovers (see Chapter 6).
- Unused general business credit carryovers (see Chapter 14).
- Suspended or current passive activity losses (see Chapter 6).

LIKE-KIND PROPERTY

The term *like-kind* is explained in the Regulations as follows: "The words 'like-kind' refer to the nature or character of the property and not to its grade or quality. One kind or class of property may not . . . be exchanged for property of a different kind or class."[54] The Regulations go on to explain that although real estate can be exchanged only for other real estate, the definition of real estate is quite broad. *Real*

[54]Reg. § 1.1031(a)–1(b).

Popularity of Like-Kind Exchanges Grow

A taxpayer who engages in a like-kind exchange must report the transaction to the IRS using Form 8824. The IRS Office of Research, Analysis, and Statistics reports that in tax year 2005 taxpayers filed more than 429,000 Forms 8824 claiming deferred gains (or losses) of more than $101.3 billion. This represents a doubling of the number of like-kind exchanges reported in 2001.

Source: Guidance Could Be Enhanced for Deciding to Use a Qualified Intermediary in Like-Kind Exchanges, *Treasury Inspector General for Tax Administration*, August 27, 2008, Reference Number: 2008-30-154.

estate (or realty) includes principally rental buildings, office and store buildings, manufacturing plants, warehouses, and land. It is immaterial whether real estate is improved or unimproved. Thus, unimproved land can be exchanged for an apartment house. On the other hand, real property located in the United States exchanged for foreign real property (and vice versa) does not qualify as like-kind property. A similar provision applies to exchanges of foreign and domestic personalty.

In any case, real estate cannot be exchanged in a like-kind transaction for personalty. *Personalty* includes tangible assets other than real estate, such as machinery, equipment, trucks, automobiles, furniture, and fixtures. Thus, an exchange of a machine (personalty) for a small office building (realty) is not a like-kind exchange. Finally, the Code mandates that livestock of different sexes are not like-kind property.

Pheasant, Inc., made the following exchanges during the taxable year:

a. Inventory for a machine used in business.
b. Land held for investment for a building used in business.
c. Stock held for investment for equipment used in business.
d. A light-duty business truck for a light-duty business truck.
e. Livestock for livestock of a different sex.
f. Land held for investment in New York for land held for investment in London.

Exchanges (b), investment real property for business real property, and (d), business personalty for business personalty, qualify as exchanges of like-kind property. Exchanges (a), inventory; (c), stock; (e), livestock of different sexes; and (f), U.S. and foreign real estate do not qualify. ■

DIGGING DEEPER 8

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

The Regulations dealing with § 1031 like-kind exchanges provide greater specificity when determining whether depreciable tangible personalty is of a like kind. Such property held for productive use in a business is of like kind only if the exchanged property is within the same *general business asset class* (as specified by the IRS in Rev.Proc. 87–56 or as subsequently modified) or the same *product class* (as specified by the Department of Commerce). Property included in a general business asset class is evaluated exclusively under the Revenue Procedure, rather than under the product class system.

The following are examples of general business asset classes:

- Office furniture, fixtures, and equipment.
- Information systems (computers and peripheral equipment).
- Airplanes.

TAX in the NEWS

More IRS Oversight of § 1031 Exchanges

The IRS has announced that it is stepping up its oversight and enforcement of § 1031 like-kind exchanges. The announcement is in response to a report issued by the Treasury Inspector General for Tax Administration. According to the report, clearer IRS guidance on § 1031 exchanges will:

- Help taxpayers understand the qualification requirements for a § 1031 exchange.
- Help deter unscrupulous promoters from trying to abuse the use of § 1031 exchanges.

Common abuses include using properties that are not like kind, failing to comply with the statutory requirements if related parties are included in an exchange, and incorrectly determining the basis for the properties involved.

Section 1031 exchanges are reported on Form 8824 when the taxpayer files his or her income tax return. During the period from 1998 to 2004, the number of Forms 8824 filed doubled (from 338,500 to 677,000). During the same period, the deferred income resulting from § 1031 exchanges more than tripled to $73.6 billion. Of the Forms 8824 filed, 65 percent were attached to Forms 1040 with the balance being filed by partnerships and corporations.

- Automobiles and taxis.
- Buses.
- Light general-purpose trucks.
- Heavy general-purpose trucks.

These Regulations narrow the range of depreciable tangible personalty subject to § 1031 like-kind exchange treatment. For example, the exchange of office equipment for a computer does not qualify as an exchange of like-kind property. Even though both assets are depreciable tangible personalty, they are not like-kind property because they are in different general business asset classes. Accordingly, any realized *gain or loss* on the office equipment would be recognized currently.

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9 DIGGING DEEPER

Finally, a special provision applies if the taxpayers involved in the exchange are *related parties* under § 267(b). To qualify for like-kind exchange treatment, the taxpayer and the related party must not dispose of the like-kind property received in the exchange for two years after the date of the exchange. If such a disposition does occur, the postponed gain is recognized as of the date of that disposition. Dispositions due to death, involuntary conversions, and certain non-tax avoidance transactions are excepted from this rule.

EXCHANGE REQUIREMENT

The transaction must generally involve a direct exchange of property to qualify as a like-kind exchange. The sale of old property and the purchase of new property, even though like kind, is not an exchange. However, the Code does provide a limited procedure for real estate to be exchanged for qualifying property that is acquired subsequent to the exchange.[55]

Of course, the taxpayer may want to avoid nontaxable exchange treatment. Recognition of gain gives the taxpayer a higher basis for depreciation. To the extent that such gains would, if recognized, either receive favorable capital gain treatment or be

[55] § 1031(a)(3).

passive activity income that could be offset by passive activity losses, it might be preferable to avoid the nonrecognition provisions through an indirect exchange transaction. For example, a taxpayer may sell property to one company, recognize the gain, and subsequently purchase similar property from another company. The taxpayer may also want to avoid nontaxable exchange treatment so that a realized loss can be recognized.



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BOOT

If the taxpayer in a like-kind exchange gives or receives some property that is not like-kind property, recognition may occur. Property that is not like-kind property, including cash, is often referred to as **boot**. Although the term *boot* does not appear in the Code, tax practitioners commonly use it rather than saying "property that does not qualify as like-kind property."

The *receipt* of boot will trigger recognition of gain if there is realized gain. The amount of the recognized gain is the *lesser* of the boot received or the realized gain (realized gain serves as the ceiling on recognition).

EXAMPLE 33

Blue, Inc., and White Corporation exchange machinery, and the exchange qualifies as like kind under § 1031. Since Blue's machinery (adjusted basis of $20,000) is worth $24,000 and White's machine has a fair market value of $19,000, White also gives Blue cash of $5,000. Blue's recognized gain is $4,000, the lesser of the realized gain of $4,000 ($24,000 amount realized − $20,000 adjusted basis) or the fair market value of the boot received of $5,000. ■

EXAMPLE 34

Assume the same facts as in the preceding example, except that White's machine is worth $21,000 (not $19,000). Under these circumstances, White gives Blue cash of $3,000 to make up the difference. Blue's recognized gain is $3,000, the lesser of the realized gain of $4,000 ($24,000 amount realized − $20,000 adjusted basis) or the fair market value of the boot received of $3,000. ■

The receipt of boot does not result in recognition if there is realized loss.

EXAMPLE 35

Assume the same facts as in Example 34, except that the adjusted basis of Blue's machine is $30,000. Blue's realized loss is $6,000 ($24,000 amount realized − $30,000 adjusted basis). The receipt of the boot of $5,000 does not trigger recognition of Blue's loss. ■

The *giving* of boot does not trigger recognition if the boot consists solely of cash.

EXAMPLE 36

Flicker, Inc., and Gadwall Corporation exchange equipment in a like-kind exchange. Flicker receives equipment with a fair market value of $25,000 and transfers equipment worth $21,000 (adjusted basis of $15,000) and cash of $4,000. Flicker's realized gain is $6,000 ($25,000 amount realized − $15,000 adjusted basis − $4,000 cash), none of which is recognized. ■

If, however, the boot given is appreciated or depreciated property, gain or loss is recognized to the extent of the difference between the adjusted basis and the fair market value of the boot. For this purpose, *appreciated or depreciated property* is property with an adjusted basis that differs from fair market value.

EXAMPLE 39

Assume the same facts as in the preceding example, except that Flicker transfers equipment worth $10,000 (adjusted basis of $12,000) and boot worth $15,000 (adjusted basis of $9,000). Flicker's realized gain appears to be $4,000 ($25,000 amount realized − $21,000 adjusted basis). Since realization previously has served as a ceiling on recognition, it appears that the recognized gain is $4,000 (lower of realized gain of $4,000 or amount of appreciation on boot of $6,000). However, the recognized gain actually is $6,000 (full amount of the appreciation on the boot). In effect, Flicker must calculate the like-kind and boot parts of the transaction separately. That is, the realized loss of $2,000 on the like-kind property *is not* recognized ($10,000 fair market value − $12,000 adjusted basis), but the $6,000 realized gain on the boot *is* recognized ($15,000 fair market value − $9,000 adjusted basis). ■

BASIS AND HOLDING PERIOD OF PROPERTY RECEIVED

If an exchange does not qualify as nontaxable under § 1031, gain or loss is recognized, and the basis of property received in the exchange is the property's fair market value. If the exchange qualifies for nonrecognition, the basis of property received must be adjusted to reflect any postponed (deferred) gain or loss. The *basis of like-kind property* received in the exchange is the property's fair market value less postponed gain or plus postponed loss. The *basis* of any *boot* received is the boot's fair market value.

EXAMPLE 40

Vireo Property Management Company exchanges a building (used in its business) with an adjusted basis of $300,000 and a fair market value of $380,000 for land with a fair market value of $380,000. The land is to be held as an investment. The exchange qualifies as like kind (an exchange of business real property for investment real property). Thus, the basis of the land is $300,000 (the land's fair market value of $380,000 less the $80,000 postponed gain on the building). If the land is later sold for its fair market value of $380,000, the $80,000 postponed gain is recognized. ■

EXAMPLE 41

Assume the same facts as in the preceding example, except that the building has an adjusted basis of $480,000 and a fair market value of only $380,000. The basis in the newly acquired land is $480,000 (fair market value of $380,000 plus the $100,000 postponed loss on the building). If the land is later sold for its fair market value of $380,000, the $100,000 postponed loss is recognized. ■

The Code provides an alternative approach for determining the basis of like-kind property received:

Adjusted basis of like-kind property surrendered
+ Adjusted basis of boot given
+ Gain recognized
− Fair market value of boot received
− Loss recognized
= *Basis of like-kind property received*

This approach accords with the recovery of capital doctrine. That is, the unrecovered cost or other basis is increased by additional cost (boot given) or decreased by cost recovered (boot received). Any gain recognized is included in the basis of the new property. The taxpayer has been taxed on this amount and is now entitled to recover it tax-free. Any loss recognized is deducted from the basis of the new property since the taxpayer has already received a tax benefit on that amount.

The holding period of the property surrendered in the exchange carries over and *tacks on* to the holding period of the like-kind property received.[56] This rule

[56] § 1223(1) and Reg. § 1.1223–1(a). For like-kind exchanges after March 1, 1954, the tacked-on holding period applies only if the like-kind property surrendered was either a capital asset or § 1231 property. See Chapter 8 for the discussion of capital assets and § 1231 property.

derives from the basic concept that the new property is a continuation of the old investment. The boot received has a new holding period (from the date of exchange) rather than a carryover holding period.

Depreciation recapture potential carries over to the property received in a like-kind exchange.[57] See Chapter 8 for a discussion of this topic.



In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

If the taxpayer either assumes a liability or takes property subject to a liability, the amount of the liability is treated as boot given. For the taxpayer whose liability is assumed or whose property is taken subject to the liability, the amount of the liability is treated as boot received. The following example illustrates the effect of such a liability. In addition, the example illustrates the tax consequences for both parties involved in the like-kind exchange.

EXAMPLE 31

Jaeger & Company and Lark Enterprises, Inc., exchange real estate investments. Jaeger gives up property with an adjusted basis of $250,000 (fair market value of $400,000) that is subject to a mortgage of $75,000 (assumed by Lark). In return for this property, Jaeger receives property with a fair market value of $300,000 (adjusted basis of $200,000) and cash of $25,000.[58]

	Jaeger	Lark
Amount realized:		
Like-kind property received	$ 300,000	$ 400,000
Boot received:		
Cash	25,000	
Mortgage assumed	75,000	
	$ 400,000	$ 400,000
Adjusted basis:		
Like-kind property given	(250,000)	(200,000)
Boot given:		
Cash		(25,000)
Mortgage assumed		(75,000)
Realized gain	$ 150,000	$ 100,000
Recognized gain	100,000*	–0–**
Deferred gain	$ 50,000	$ 100,000
Basis of property transferred:		
Like-kind property	$ 250,000	$ 200,000
Cash		25,000
Mortgage assumed		75,000
	$ 250,000	$ 300,000
Plus: Gain recognized	100,000	
Less: Boot received	(100,000)	
Basis of new property	$ 250,000	$ 300,000

*Lesser of boot received ($25,000 cash + $75,000 mortgage assumed = $100,000) or gain realized ($150,000).
**No boot received. Therefore, no gain is recognized. ■

[57] Reg. §§ 1.1245–2(a)(4) and 1.1250–2(d)(1).

[58] Example (2) of Reg. § 1.1031(d)–2 illustrates a special situation in which both the buyer and the seller transfer liabilities that are assumed by the other party or both parties acquire property that is subject to a liability.



Bridge to Economics

One can assert that the "tax variable" is neutralized in nontaxable exchanges when taxable gains or losses do not arise. Neutralizing potential tax consequences can have a positive result given that tax costs tend to dampen economic activity. For example, in a like-kind exchange, a taxpayer can exchange one asset for another asset of like kind without having to recognize a gain or pay a tax. The justification for the tax deferral is that the taxpayer is viewed as having an equivalent economic investment after the transaction as before the transaction. But the tax-neutral result changes when the taxpayer receives property that is not "like kind" because the taxpayer's economic standing has changed.

If, for example, the taxpayer receives investment land *and* cash in exchange for investment land, her ownership in the land given up has, at least in part, been converted to cash, and to that degree, her investment has substantively changed. That is, the taxpayer's economic investment has changed from an ownership exclusively in land to ownership in land *and* cash. Alternatively, if the taxpayer gives up her investment land for corporate stock in a high-tech venture, the nature of her investment also would substantively change as a result of the transaction. These differences in the taxpayer's economic position after the transaction lead to the transactions being taxed.

7.5 Involuntary Conversions—§ 1033

LO.6

Explain the nonrecognition provisions available on the involuntary conversion of property.

Section 1033 provides that a taxpayer who suffers an involuntary conversion of property may postpone recognition of *gain* realized from the conversion, if that taxpayer *reinvests* the amount realized from the conversion in replacement property. Thus, if the amount reinvested in replacement property is *less than* the amount realized, realized gain *is recognized*, but only to the extent of the amount not reinvested. Any realized gain not recognized reduces the taxpayer's basis in the replacement property.[59] Thus, recognition of the gain is deferred until the replacement property is disposed of.

EXAMPLE 12

Sandpiper, Inc., receives insurance proceeds of $29,000 when some of its manufacturing equipment (adjusted basis of $25,000) is destroyed by fire. Sandpiper purchases new equipment costing $30,000, so none of its $4,000 realized gain ($29,000 amount realized − $25,000 adjusted basis) is recognized. Sandpiper's basis in the new equipment is $26,000 ($30,000 cost − $4,000 deferred gain). ■

EXAMPLE 13

If Sandpiper, Inc., in the preceding example purchases new equipment that costs $28,000, it would recognize gain of $1,000, the difference between the $29,000 of insurance proceeds realized on the conversion and the $28,000 cost of the new equipment. The remaining $3,000 of realized gain would not be recognized; instead, it would reduce the company's basis in the new equipment to $25,000 ($28,000 cost − $3,000 deferred gain). ■

By its terms, § 1033 is *elective*. A taxpayer need not postpone recognition of gain, even if replacement property is acquired. In essence, a taxpayer has three options:

- Reinvest the proceeds and elect § 1033's nonrecognition of gain.
- Reinvest the proceeds and not elect § 1033, thereby triggering recognition of realized gain under the customary rules applicable to property transactions.
- Not reinvest the proceeds and recognize the realized gain accordingly.

If a *loss* occurs on an involuntary conversion, § 1033 does not apply, and the general rules for loss recognition are effective. See Chapter 6 for the discussion of the deduction of losses.

[59] § 1033(b)(2).

Tax Planning Strategies **RECOGNIZING INVOLUNTARY CONVERSION GAINS**

FRAMEWORK FOCUS: TAX RATE

Strategy: Shift Net Income from High-Bracket Years to Low-Bracket Years.

FRAMEWORK FOCUS: DEDUCTIONS

Strategy: Maximize Deductible Amounts.

Sometimes, a taxpayer may prefer to *recognize a gain from an involuntary conversion* and will choose not to elect §1033, even though replacement property is acquired. Circumstances suggesting this strategy would include:

- The taxpayer realized the gain in a low-bracket tax year, quite possibly because of the events that caused the involuntary conversion, such as a flood and its aftermath that seriously disrupted the business.
- The taxpayer has an expiring net operating loss carryover that can offset most, if not all, of the gain from the involuntary conversion.
- The replacement property is depreciable, and the taxpayer would prefer an unreduced basis for this asset to maximize depreciation deductions in future years.

Nontax considerations might also come into play, perhaps suggesting that the property not be replaced at all. Even before the event that produced the involuntary conversion, the taxpayer might have been wanting to downsize the business or terminate it outright. In any case, the taxpayer might prefer to recognize the gain, pay the tax involved, and thereby free up the remaining proceeds for other uses—business, investment, or even personal—especially if the gain is small compared to the amount of proceeds received.

INVOLUNTARY CONVERSION DEFINED

An **involuntary conversion** results from the destruction (complete or partial), theft, seizure, requisition or condemnation, or sale or exchange under threat or imminence of requisition or condemnation of the taxpayer's property.[60] This description includes fires (other than arson),[61] tornadoes, hurricanes, earthquakes, floods, and other natural disasters. In these circumstances, *gain* can result from insurance proceeds received in an amount that exceeds the taxpayer's historical cost of the property, especially if depreciation deductions have lowered the property's adjusted basis.

For requisitions and condemnations, the amount realized includes the compensation paid by the public authority acquiring the taxpayer's property. To prove the existence of a threat or imminence of condemnation, the taxpayer must obtain confirmation that there has been a decision to acquire the property for public use. In addition, the taxpayer must have reasonable grounds to believe the property will be taken.[62] The property does not have to be sold to the authority threatening to condemn it to qualify for § 1033 postponement. If the taxpayer satisfies the confirmation and reasonable grounds requirements, he or she can sell the property to another party.[63] Likewise, the sale of property to a condemning authority by a taxpayer who acquired the property from its former owner with the knowledge that the property was under threat of condemnation also qualifies as an involuntary conversion under § 1033.[64]

[60] § 1033(a) and Reg. §§ 1.1033(a)–1(a) and –2(a).
[61] Rev.Rul. 82–74, 1982–1 C.B. 110.
[62] Rev.Rul. 63–221, 1963–2 C.B. 332, and *Joseph P. Balistrieri*, 38 TCM 526, T.C.Memo. 1979–115.
[63] Rev.Rul. 81–180, 1981–2 C.B. 161.
[64] Rev.Rul. 81–181, 1981–2 C.B. 162.

TAX in the NEWS

Restricting Eminent Domain: Who Is Harmed?

In *Kelo v. City of New London*, the U.S. Supreme Court ruled that the U.S. Constitution permits the condemnation of private property for purposes that are primarily commercial as long as the taking serves a demonstrated "public use." In that case, "public use" was deemed to occur because benefits would accrue to the city in the form of new jobs and increased tax revenues when a "blighted" area was condemned for a private development.

However, the decision does not preclude states from enacting laws that restrict the use of condemnation powers. To date, 42 states have passed laws imposing some restriction on the use of eminent domain. These laws have varied from broad restrictions (e.g., a 10-year waiting period after seizure) to a much narrower approach (e.g., modifying the definition of "blight").

Those who oppose any limits on eminent domain argue that such state laws unfairly restrict redevelopment and harm the economy. To test this theory, the Institute of Justice undertook a study to ascertain if such laws resulted in decreased economic growth. The study concluded that even in the states with the broadest reforms, state-imposed restrictions on eminent domain have had no discernible impact on economic activity.

As an aside, all has not gone well with the planned real estate development in New London. The city and the state spent about $78 million to "get" the property to make it available for private development and to create jobs. Four years after the Supreme Court decision, one of the major players has pulled out and the wrecked and condemned neighborhood stands vacant.

Sources: Adapted from "Eminent Reality," *Wall Street Journal*, January 30, 2008, p. A16; "Pfizer and Kelo's Ghost Town," *Wall Street Journal*, November 11, 2009, p. A20.

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

12 DIGGING DEEPER

REPLACEMENT PROPERTY

The requirements for replacement property under the involuntary conversion rules generally are more restrictive than those for like-kind property under § 1031. The basic requirement is that the replacement property be similar or related in service or use to the involuntarily converted property.[65]

Different interpretations of the phrase *similar or related in service or use* apply depending on whether the involuntarily converted property is held by an *owner-user* or by an *owner-investor* (e.g., lessor). For an owner-user, the *functional use test* applies, and for an owner-investor, the *taxpayer use test* applies.

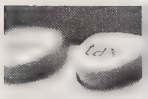
Functional Use Test

Under this test, a taxpayer's use of the replacement property and of the involuntarily converted property must be the same. Replacing a manufacturing plant with a wholesale grocery warehouse does not meet this test. Instead, the plant must be replaced with another facility of similar functional use.

Taxpayer Use Test

The taxpayer use test for owner-investors provides the taxpayer with more flexibility in terms of what qualifies as replacement property than does the functional use test for owner-users. Essentially, the properties must be used by the taxpayer (the owner-investor) in similar endeavors. For example, rental property held by an owner-investor qualifies if replaced by other rental property, regardless of the type of rental property involved. The test is met when an investor replaces a manufacturing plant with a wholesale grocery warehouse if both properties are held for the production of

[65] § 1033(a) and Reg. § 1.1033(a)–1.



CONCEPT SUMMARY 7.3

Replacement Property Tests

Type of Property and User	Like-Kind Test	Taxpayer Use Test	Functional Use Test
Land used by a manufacturing company is condemned by a local government authority.	X		
Apartment and land held by an investor are sold due to the threat or imminence of condemnation.	X		
An investor's rented shopping mall is destroyed by fire; the mall may be replaced by other rental properties (e.g., an apartment building).		X	
A manufacturing plant is destroyed by fire; replacement property must consist of another manufacturing plant that is functionally the same as the property converted.			X
Personal residence of taxpayer is condemned by a local government authority; replacement property must consist of another personal residence.			X

rental income.[66] The replacement of a rental residence with a personal residence does not meet the test.[67]

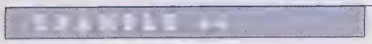
Special Real Property Test

In addition to the functional and taxpayer use tests, the Code provides a special rule for business or investment real property *that is condemned.* This rule applies the broad like-kind classification for real estate to such circumstances. Accordingly, improved real property can be replaced with unimproved real property.

The rules concerning the nature of replacement property are illustrated in Concept Summary 7.3.

TIME LIMITATION ON REPLACEMENT

The taxpayer normally has a two-year period after the close of the taxable year in which gain is realized from an involuntary conversion to replace the property (*the latest date*).[68] This rule affords as much as three years from the date of realization of gain to replace the property if the realization of gain took place on the first day of the taxable year.[69] If the involuntary conversion involved the condemnation of real property used in a trade or business or held for investment, the Code substitutes a three-year period for the normal two-year period. In this case, a taxpayer might have as much as four years from the date of realization of gain to replace the property.



Magpie, Inc.'s warehouse is destroyed by fire on December 16, 2009. The adjusted basis is $325,000. Magpie receives $400,000 from the insurance company on January 10, 2010. The company is a calendar year taxpayer. The latest date for replacement is December 31, 2012 (the end of the taxable year in which realized gain occurred plus two years). The critical date is not the date the involuntary conversion occurred, but rather the date of gain realization (when the insurance proceeds are received). ■

[66] *Loco Realty Co. v. Comm.*, 62–2 USTC ¶9657, 10 AFTR 2d 5359, 306 F.2d 207 (CA–8, 1962).

[67] Rev.Rul. 70–466, 1970–2 C.B. 165.

[68] §§ 1033(a)(2)(B) and (g)(4) and Reg. § 1.1033(a)–2(c)(3).

[69] A taxpayer can apply for an extension of this time period anytime before its expiration [Reg. § 1.1033(a)–2(c)(3)]. Also, the period for filing the application for extension can be extended if a taxpayer shows reasonable cause.

Assume the same facts as in the preceding example, except that Magpie's warehouse is condemned. The latest date for replacement is December 31, 2013 (the end of the taxable year in which realized gain occurred plus three years). ■

The *earliest date* for replacement typically is the date the involuntary conversion occurs. However, if the property is condemned, it is possible to replace the condemned property before this date. In this case, the earliest date is the date of the threat or imminence of requisition or condemnation of the property. The purpose of this provision is to enable the taxpayer to make an orderly replacement of the condemned property.

7.6 Other Nonrecognition Provisions

LO.7

Identify other nonrecognition provisions contained in the Code.

Several additional nonrecognition provisions are treated briefly in the remainder of this chapter.

TRANSFER OF ASSETS TO BUSINESS ENTITY—§§ 351 AND 721

Taxpayers can transfer assets to corporations in exchange for stock without recognizing gain or loss on the transfer according to § 351. See Chapter 9 for the applicable restrictions and corresponding basis adjustments for the stock acquired. A similar provision (§ 721) allows the nontaxable transfer of assets to a partnership in exchange for an interest in that partnership. See Chapter 11 for a description of § 721.

EXCHANGE OF STOCK FOR PROPERTY—§ 1032

Under § 1032, a corporation does not recognize gain or loss on the receipt of money or other property in exchange for its stock (including treasury stock). In other words, a corporation does not recognize gain or loss when it deals in its own stock. This provision accords with the accounting treatment of such transactions.

CERTAIN EXCHANGES OF INSURANCE POLICIES—§ 1035

Under § 1035, no gain or loss is recognized from the exchange of certain insurance contracts or policies. The rules relating to exchanges not solely in kind (i.e., with boot) and the basis of the property acquired are the same as under § 1031. Exchanges qualifying for nonrecognition include the following:

- The exchange of life insurance contracts.
- The exchange of a life insurance contract for an endowment or annuity contract.
- The exchange of an endowment contract for another endowment contract that provides for regular payments beginning at a date not later than the date payments would have begun under the contract exchanged.
- The exchange of an endowment contract for an annuity contract.
- The exchange of annuity contracts.

EXCHANGE OF STOCK FOR STOCK OF THE SAME CORPORATION—§ 1036

Section 1036 provides that a shareholder does not recognize gain or loss on the exchange of common stock solely for common stock in the same corporation or from the exchange of preferred stock for preferred stock in the same corporation. Exchanges between individual shareholders as well as between a shareholder and the corporation are included under this nonrecognition provision. The rules

relating to exchanges not solely in kind and the basis of the property acquired are the same as under § 1031. For example, a nonrecognition exchange occurs when common stock with different rights, such as voting for nonvoting, is exchanged. A shareholder usually recognizes gain or loss from the exchange of common for preferred or preferred for common even though the stock exchanged is in the same corporation.

ROLLOVERS INTO SPECIALIZED SMALL BUSINESS INVESTMENT COMPANIES—§ 1044

Section 1044 provides a postponement opportunity associated with the sale of publicly traded securities. If the amount realized is reinvested in the common stock or partnership interest of a specialized small business investment company (SSBIC), the realized gain is not recognized. Gain will be recognized, however, to the extent of any amount not reinvested. To qualify, the taxpayer must reinvest the proceeds within 60 days of the date of sale. In calculating the basis of the SSBIC stock, the amount of the purchase price is reduced by the amount of the postponed gain.

Statutory ceilings are imposed on the amount of realized gain that can be postponed for any taxable year as follows:

- For an individual taxpayer, the lesser of:
  - $50,000 ($25,000 for married filing separately).
  - $500,000 ($250,000 for married filing separately) reduced by the amount of such nonrecognized gain in all preceding taxable years.
- For a corporate taxpayer, the lesser of:
  - $250,000.
  - $1 million reduced by the amount of such nonrecognized gain in all preceding taxable years.

Investors ineligible for this postponement treatment include partnerships, S corporations, estates, and trusts.



In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

SALE OF A PRINCIPAL RESIDENCE—§ 121

Section 121 allows individual taxpayers to exclude gain from the sale of a *principal residence.* This provision applies to the first $250,000 of realized gain, or $500,000 on a joint return. For this purpose, the residence must have been owned and used by the taxpayer as the primary residence for at least two of the five years preceding the date of sale. In addition, the exclusion is not available for sales occurring within two years of its last use. This exclusion can be prorated, however, if a taxpayer failed to meet one or more of these time period requirements due to a change in his or her place of employment or health. Moreover, a surviving spouse counts the ownership and usage periods of the decedent spouse in meeting the two-year test. This provision applies only to gains; losses on residences, like those of other personal-use assets, are not recognized for tax purposes.



In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

TRANSFERS OF PROPERTY BETWEEN SPOUSES OR INCIDENT TO DIVORCE—§ 1041

Section 1041 provides for nontaxable exchange treatment on property transfers *between spouses during marriage.* The basis to the recipient spouse is a carryover basis.

Section 1041 also provides that transfers of property *between spouses or former spouses incident to divorce* are nontaxable transactions. Therefore, the basis to the recipient is a carryover basis. To be treated as incident to the divorce, the transfer must be related to the cessation of marriage or must occur within one year after the date on which the marriage ceases.

REFOCUS ON THE BIG PICTURE

CALCULATING BASIS AND RECOGNIZED GAIN FOR PROPERTY TRANSACTIONS

Alice's basis in the land acquired as a gift is a carryover basis of $2,000. If Alice sells the land outright, she will realize and recognize a gain of $48,000. However, if she replaces the property with other real property, she should be able to qualify for favorable like-kind exchange treatment under § 1031 and defer the gain on the property disposition. However, if Alice receives any cash from the exchange, any realized gain would be recognized to the extent of the cash (boot) received.

Alice's basis in the 300 shares of stock received as an inheritance is the property's $30,000 fair market value at the date of death. If Alice sells the 300 shares, she will realize and recognize a $6,000 gain [$36,000 sales price (300 shares × $120) − $30,000 basis].

Alice's basis in the 200 shares of stock purchased is her purchase price of $28,000. Those shares are currently worth $24,000 (200 shares × $120). Consequently, if she sells those shares, she will realize and recognize a $4,000 loss.

You advise Alice that her basis in the house is its $475,000 fair market value on the date of her grandmother's death. If Alice sells the house for $600,000, her realized and recognized gain would be $125,000.

What If?

Alice is leaning toward selling the house. However, she knows that her grandmother would not want her to have to pay income taxes on the sale. Alice asks whether there is any way that she could avoid paying taxes on the sale.

You inform Alice of the exclusion provision under § 121. Alice can qualify for this exclusion of up to $250,000 of realized gain if she owns and occupies the house as her principal residence for at least two of the five years prior to a sale.

SUGGESTED READINGS

Holly Belanger, "IRS Applies Expansive Definition of Goodwill for Section 1031 Purposes," *Business Entities,* July/August 2008.

Philip R. Fink, "Bear Market Presents Good Opportunity for Making Gifts of Securities," *Practical Tax Strategies,* May 2009.

Barbara Leonard and Gene Johnson, "Recent Law Changes Impose Restrictions on Home-Sale Exclusion," *Practical Tax Strategies,* June 2009.

Claire Y. Nash and James Parker, "Like-Kind Exchanges: Deferral Is Not Always the Best Option," *The Tax Adviser,* April 2009.

KEY TERMS

Adjusted basis, 7–4
Amount realized, 7–3
Boot, 7–24
Fair market value, 7–4
Goodwill, 7–10
Holding period, 7–13
Involuntary conversion, 7–28
Like-kind exchanges, 7–20
Nontaxable exchange, 7–20
Realized gain, 7–3
Realized loss, 7–3
Recognized gain, 7–6
Recognized loss, 7–6
Recovery of capital doctrine, 7–7
Wash sale, 7–16

PROBLEMS

1. **LO.1** If a taxpayer sells property for cash, the amount realized consists of the net proceeds from the sale. For each of the following, indicate the effect on the amount realized:
   a. The property is sold on credit.
   b. A mortgage on the property is assumed by the buyer.
   c. A mortgage on the property of the buyer is assumed by the seller.
   d. The buyer acquires the property subject to a mortgage of the seller.
   e. Stock that has a basis to the purchaser of $6,000 and a fair market value of $10,000 is received by the seller as part of the consideration.

ETHICS AND EQUITY

2. **LO.3** Martha sells her house to Sachin on November 1, 2010, for $480,000. On December 5, the property tax due date, Sachin pays property taxes of $800. Even though the property tax bill from the county is for $4,800, Sachin concludes that he owes only for the months of November and December and that the other $4,000 is Martha's liability. On Schedule A of Form 1040 for 2010, Sachin deducts the $800 of property tax he paid.

   When Sachin tries to sell his house 18 months later, he discovers that the county has placed a lien on the property. In order to get a clear title, he pays the $4,000 of property taxes due. He subsequently sells his house for a recognized gain of $38,000.

   Sachin deducts the $4,000 of property taxes that relate to the period Martha owned the house on Schedule A of his 2012 tax return.

   Has Sachin acted properly?

3. **LO.1, 2** Melanie owns a personal-use boat that has a fair market value of $32,500 and an adjusted basis of $45,000. Melanie's AGI is $90,000. Calculate the realized and recognized loss if:
   a. Melanie sells the boat for $32,500.
   b. Melanie exchanges the boat for another boat worth $32,500.
   c. The boat is stolen and Melanie receives insurance proceeds of $32,500.

4. **LO.1, 2** Hubert's personal residence is condemned as part of an urban renewal project. His adjusted basis for the residence is $325,000. He receives condemnation proceeds of $300,000 and invests the proceeds in stock.
   a. Calculate Hubert's realized and recognized gain or loss.
   b. If the condemnation proceeds are $355,000, what are Hubert's realized and recognized gain or loss?
   c. What are Hubert's realized and recognized gain or loss in (a) if the house was rental property?

5. **LO.1, 2, 3** Finch, Inc., purchases 1,000 shares of Bluebird Corporation stock on October 3, 2010, for $200,000. On December 12, 2010, Finch purchases an additional 500 shares of Bluebird stock for $112,500. According to market quotations, Bluebird stock is selling for $240 per share on December 31, 2010. Finch sells 400 shares of Bluebird stock on March 1, 2011, for $100,000.
   a. What is the adjusted basis of Finch's Bluebird stock on December 31, 2010?
   b. What is Finch's recognized gain or loss from the sale of Bluebird stock on March 1, 2011, assuming the shares sold are from the shares purchased on December 12, 2010?
   c. What is Finch's recognized gain or loss from the sale of Bluebird stock on March 1, 2011, assuming Finch cannot adequately identify the shares sold?

6. **LO.2, 3** Irene Andrews is purchasing the assets of a sole proprietorship from Seth. The fair market values of the assets as agreed to by Irene and Seth are as follows: **COMMUNICATIONS**

Asset	Seth's Adjusted Basis	Fair Market Value
Accounts receivable	$ –0–	$ 10,000
Notes receivable	15,000	20,000
Machinery and equipment	85,000	110,000
Building	100,000	320,000
Land	200,000	350,000

The purchase price is $950,000.
   a. Calculate Seth's realized and recognized gain.
   b. Determine Irene's basis for each of the assets.
   c. Write a letter to Irene informing her of the tax consequences of the purchase. Her address is 300 Riverside Drive, Cincinnati, OH 45207.

7. **LO.1, 2, 3** Roberto has received various gifts over the years. He has decided to dispose of the following assets that he received as gifts:
   a. In 1951, he received land worth $25,000. The donor's adjusted basis was $40,000. Roberto sells the land for $92,000 in 2010.
   b. In 1956, he received stock in Gold Company. The donor's adjusted basis was $22,000. The fair market value on the date of the gift was $30,000. Roberto sells the stock for $40,000 in 2010.
   c. In 1962, he received land worth $15,000. The donor's adjusted basis was $25,000. Roberto sells the land for $9,000 in 2010.
   d. In 2003, he received stock worth $30,000. The donor's adjusted basis was $42,000. Roberto sells the stock for $35,000 in 2010.

   What is the recognized gain or loss from each of the preceding transactions? Assume for each of the gift transactions that no gift tax was paid.

8. **LO.3** Holly owns stock with an adjusted basis of $2,500 and fair market value of $9,500. Holly expects the stock to continue to appreciate. Alice, Holly's best friend, has recently been operated on for cancer. Alice's physicians have told her that her life expectancy is between six months and one and a half years. One day at lunch, the two friends were discussing their tax situations (both feel they pay too much), when Alice mentioned that she had read a newspaper article about a tax planning opportunity that might be suitable for Holly. Holly would make a gift of the appreciated stock to Alice. In her will, Alice would bequeath the stock back to Holly. Since Alice is confident that she will live longer than a year, the basis of the stock to Holly would be the fair market value on the date of Alice's death. Alice would "feel good" because she had helped Holly "beat the tax system." You are Holly's tax adviser. How will you respond to Alice's proposal? Would your response change if the stock were a painting that Alice could enjoy for her remaining days? **ETHICS AND EQUITY**

9. **LO.1, 2, 3** Beth receives a car from Sam as a gift. Sam paid $35,000 for the car. He had used it for business purposes and had deducted $16,000 for depreciation up to the time he gave the car to Beth. The fair market value of the car is $15,000.
   a. Assuming Beth uses the car for business purposes, what is her basis for depreciation?
   b. What is the depreciation deduction for the first year? Assume Beth elects the straight-line method.
   c. If Beth sells the car for $4,500 one year after receiving it, what is her gain or loss?
   d. If Beth sells the car for $18,500 one year after receiving it, what is her gain or loss?

10. **LO.3** Laura receives a gift of real estate with an adjusted basis of $107,000 and a fair market value of $92,000. The donor paid gift tax of $19,000 on the transfer. If Laura later sells the property for $99,000, what is her recognized gain or loss?

11. **LO.3** In January, Agnes is diagnosed as having a terminal disease. Her nephew, Stan, will graduate from college in May, and she would like to give him $50,000 as a graduation present. She has stock worth $50,000 that she could either give him directly or sell and transfer the cash. Since she may not be alive in May, Agnes is considering making the gift **ISSUE ID**

now (four months prior to graduation). If Agnes should die before making the gift, her will stipulates that Stan will receive the stock. Identify the relevant tax issues that Agnes should consider in making her decision.

12. **LO.3** Natalie receives an original Matisse painting as a gift from her aunt. At the date of the gift, the adjusted basis of the painting is $825,000, and its fair market value is $1,120,000. Her aunt paid gift tax of $392,000.
    a. What is Natalie's adjusted basis in the painting?
    b. If the fair market value of the painting at the date of the gift is $824,000 (not $1,120,000), what is Natalie's adjusted basis?

13. **LO.3** As sole heir, Dazie receives all of Mary's property (adjusted basis of $1,400,000 and fair market value of $3,820,000). Six months after Mary's death, the fair market value is $3,835,000.
    a. Can the executor of Mary's estate elect the alternate valuation date and amount?
    b. What is Dazie's basis for the property?
    c. Assume, instead, that the fair market value six months after Mary's death is $3.8 million. Respond to (a) and (b).

14. **LO.3** The portion of Earl's estate distributed to Robert, one of Earl's beneficiaries, is valued as follows:

Asset	Earl's Adjusted Basis	FMV at Date of Death	FMV at Alternate Valuation Date
Cash	$10,000	$ 10,000	$ 10,000
Stock	40,000	125,000	60,000
Apartment building	60,000	300,000	325,000
Land	75,000	100,000	110,000

Although the fair market value of the stock six months after Earl's death turned out to be $60,000, the executor of the estate distributed it to Robert one month after Earl's death when it was worth $85,000. Determine Robert's basis for the assets if:
    a. The primary valuation date applies.
    b. The executor elects the alternate valuation date.

DECISION MAKING

15. **LO.4** Joyce owns undeveloped real estate with an adjusted basis of $120,000. She sells the real estate to her sister, Iris, for its fair market value of $115,000.
    a. Calculate Joyce's realized and recognized gain or loss.
    b. If Iris later sells the real estate for $119,000, calculate her realized and recognized gain or loss.
    c. Assume instead that Joyce sold the real estate to Iris for its fair market value of $130,000. Calculate Joyce's realized and recognized gain or loss.
    d. Assume instead that Joyce sold the real estate to Hector, a friend, for its fair market value of $115,000. Calculate Joyce's realized and recognized gain or loss.
    e. Advise Joyce whether she should sell the real estate to Iris or Hector for its fair market value of $115,000.

DECISION MAKING

16. **LO.1, 2, 3, 4** Tyneka inherited 1,000 shares of Aqua, Inc. stock from Joe. Joe's basis was $35,000, and the fair market value on July 1, 2010 (the date of death) was $45,000. The shares were distributed to Tyneka on July 15, 2010. Tyneka sold the stock on July 30, 2011, for $33,000. After giving the matter more thought, she decides that Aqua is a good investment and purchases 1,000 shares for $30,000 on August 20, 2011.
    a. What is Tyneka's basis for the 1,000 shares purchased on August 20, 2011?
    b. What would be Tyneka's basis for the 1,000 Aqua shares inherited from Joe if she had given 1,000 Aqua shares to Joe on March 1, 2010 (assuming no gift tax was paid)? Her basis at the date of the gift was $35,000, and the fair market value was $45,000.
    c. Could Tyneka have obtained different tax consequences in (a) if she had sold the 1,000 shares on December 27, 2010, and purchased the 1,000 shares on January 5, 2011?

17. **LO.1, 2, 4** Jean's home had a basis of $260,000 ($60,000 attributable to the land) and a fair market value of $250,000 when she converted half of it to business use by opening a bed and breakfast. Five years after the conversion, Jean sells the home for $375,000 ($75,000 attributable to the land).
    a. Calculate Jean's basis for gain, loss, and cost recovery for the portion of her personal residence that was converted to business use.

b. Calculate the cost recovery deducted by Jean during the five-year period of business use, assuming the bed and breakfast is opened on January 1 of year 1 and the house is sold on December 31 of year 5.
c. What is Jean's recognized gain or loss on the sale of the business-use portion?

18. **LO.4** Surendra's personal residence originally cost $340,000 (ignore land). After living in the house for five years, he converts it to rental property. At the date of conversion, the fair market value of the house is $320,000. As to the rental property, calculate Surendra's basis for:
CRITICAL THINKING
DECISION MAKING
a. Loss.
b. Depreciation.
c. Gain.
d. Could Surendra have obtained better tax results if he had sold his personal residence for $320,000 and then purchased another house for $320,000 to hold as rental property?

19. **LO.5** When no boot is given or received in a like-kind exchange, the basis of the property received is the same as the basis of the property transferred. What effect does the receipt of boot have on the basis of the like-kind property received? What if boot is given?

20. **LO.6** A warehouse owned by Marmot & Squirrel (a partnership) and used in its business (i.e., to store inventory) is being condemned by the city to provide a right of way for a highway. The warehouse has appreciated by $100,000 based on an estimate of fair market value. In the negotiations, the city is offering $40,000 less than what Marmot & Squirrel believes the property is worth. Alan, a real estate broker, has offered to purchase the property for $25,000 more than the city's offer. The partnership plans to invest the proceeds it will receive in an office building that it will lease to various tenants. Identify the relevant tax issues for Marmot & Squirrel.
ISSUE ID

21. **LO.5** Tanya Fletcher owns undeveloped land (adjusted basis of $80,000 and fair market value of $92,000) on the East Coast. On January 4, 2010, she exchanges it with her sister, Lisa, for undeveloped land on the West Coast and $3,000 cash. Lisa has an adjusted basis of $72,000 for her land, and its fair market value is $89,000. As the real estate market on the East Coast is thriving, on September 1, 2011, Lisa sells the land she acquired for $120,000.
DECISION MAKING
COMMUNICATIONS
a. What are Tanya's recognized gain or loss and adjusted basis for the West Coast land on January 4, 2010?
b. What are Lisa's recognized gain or loss and adjusted basis for the East Coast land on January 4, 2010?
c. What is Lisa's recognized gain or loss from the September 1, 2011 sale?
d. What effect does Lisa's 2011 sale have on Tanya?
e. Write a letter to Tanya advising her on how she could avoid any recognition of gain associated with the January 4, 2010 exchange prior to her actual sale of the land. Her address is The Corral, El Paso, TX 79968.

22. **LO.5** Starling Corporation exchanges a yellow bus (used in its business) for Robin Corporation's gray bus and some garage equipment (used in its business). The assets have the following characteristics:

	Adjusted Basis	Fair Market Value
Yellow bus	$7,000	$9,000
Gray bus	1,000	5,000
Equipment	2,000	4,000

a. What are Starling's recognized gain or loss and basis for the gray bus and garage equipment?
b. What are Robin's recognized gain or loss and basis for the yellow bus?

23. **LO.5** Oak Company owns undeveloped land (adjusted basis of $275,000) that it exchanges for $45,000 cash and an office building (fair market value of $320,000) to be used in the business.
a. What is Oak's realized gain or loss?
b. Its recognized gain or loss?
c. Its basis in the office building?

ISSUE ID

24. **LO.5** Tulip, Inc., would like to dispose of some land that it acquired four years ago because the land will not continue to appreciate. Its value has increased by $50,000 over the four-year period. The company also intends to sell stock that has declined in value by $50,000 during the six months since its purchase. Tulip has four offers to acquire the stock and land:

Buyer number 1:	Exchange land.
Buyer number 2:	Purchase land for cash.
Buyer number 3:	Exchange stock.
Buyer number 4:	Purchase stock for cash.

Identify the tax issues relevant to Tulip in disposing of this land and stock.

25. **LO.5** What is the basis of the new property in each of the following exchanges?
    a. Apartment building held for investment (adjusted basis of $145,000) for office building to be held for investment (fair market value of $225,000).
    b. Land and building used as a barber shop (adjusted basis of $190,000) for land and building used as a grocery store (fair market value of $350,000).
    c. Office building (adjusted basis of $45,000) for bulldozer (fair market value of $42,000), both held for business use.
    d. IBM common stock (adjusted basis of $20,000) for ExxonMobil common stock (fair market value of $28,000).
    e. Rental house (adjusted basis of $90,000) for mountain cabin to be held for personal use (fair market value of $225,000).

DECISION MAKING

COMMUNICATIONS

26. **LO.5** Hyacinth Realty Company owns land in Iowa that was originally purchased for $130,000. Hyacinth has received an all-cash offer in the amount of $400,000 from a well-known shopping center developer. An international real estate broker has now offered some land located outside Florence, Italy, that is worth $400,000 in exchange for the Iowa property. Please write the company a letter analyzing these options from a tax standpoint. Hyacinth's address is 2501 Longview Lane, Des Moines, IA 50311.

DECISION MAKING

27. **LO.5** Normandy Company owns Machine A (adjusted basis of $12,000; fair market value of $18,000), which it uses in its business. Normandy is considering two options for the disposal of Machine A. Under the first option, it will transfer Machine A and $3,000 cash to Joan, a dealer, in exchange for Machine B (fair market value of $21,000). Under the second option, Normandy will sell Machine A for $18,000 to Tim, another dealer, and then purchase Machine B from Joan for $21,000. Machines A and B qualify as like-kind property.
    a. Calculate Normandy's recognized gain or loss and the basis of Machine B under the first option.
    b. Calculate Normandy's recognized gain or loss and the basis of Machine B under the second option.
    c. Advise Normandy on which option is preferable.

28. **LO.5** Cardinal Properties, Inc., exchanges real estate held for investment plus stock for real estate to be held for investment. The stock transferred has an adjusted basis of $30,000 and a fair market value of $35,000. The real estate transferred has an adjusted basis of $40,000 and a fair market value of $112,000. The real estate acquired has a fair market value of $147,000.
    a. What is Cardinal's realized gain or loss?
    b. Its recognized gain or loss?
    c. The basis of the newly acquired real estate?

DECISION MAKING

29. **LO.5** Tom and Frank are brothers. Each owns investment property in the other's hometown. To make their lives easier, they decide to legally exchange the investment properties. Under the terms of the exchange, Frank will transfer realty (adjusted basis of $52,000; fair market value of $80,000), and Tom will exchange realty (adjusted basis of $60,000; fair market value of $92,000). Tom's property is subject to a mortgage of $12,000 that will be assumed by Frank.
    a. What are Frank's and Tom's recognized gains?
    b. What are their adjusted bases?
    c. As an alternative, Frank has proposed that rather than assuming the mortgage, he will transfer cash of $12,000 to Tom. Tom would use the cash to pay off the mortgage. Advise Tom on whether this alternative would be beneficial to him from a tax perspective.

30. **LO.5** Determine the realized, recognized, and postponed gain or loss and the new basis for each of the following like-kind exchanges:

	Adjusted Basis of Old Asset	Boot Given	Fair Market Value of New Asset	Boot Received
a.	$ 7,000	$ –0–	$12,000	$4,000
b.	14,000	2,000	15,000	–0–
c.	3,000	7,000	8,000	500
d.	22,000	–0–	32,000	–0–
e.	10,000	–0–	11,000	1,000
f.	10,000	–0–	8,000	–0–

31. **LO.5** Turquoise Realty Company owns an apartment house that has an adjusted basis of $950,000 but is subject to a mortgage of $240,000. Turquoise transfers the apartment house to Dove, Inc., and receives from Dove $150,000 in cash and an office building with a fair market value of $975,000 at the time of the exchange. Dove assumes the $240,000 mortgage on the apartment house.
    a. What is Turquoise's realized gain or loss?
    b. What is its recognized gain or loss?
    c. What is the basis of the newly acquired office building?

32. **LO.6** For each of the following involuntary conversions, indicate whether the property acquired qualifies as replacement property, the recognized gain, and the basis for the property acquired:
    a. A warehouse is destroyed by a tornado. The space in the warehouse was rented to various tenants. The adjusted basis was $470,000. The owner of the warehouse uses all of the insurance proceeds of $700,000 to build a shopping mall in a neighboring community where no property has been damaged by tornadoes. The shopping mall is rented to various tenants.
    b. A warehouse is destroyed by fire. The adjusted basis is $300,000. Because of economic conditions in the area, the owner decides not to rebuild the warehouse. Instead, it uses all of the insurance proceeds of $400,000 to build a warehouse in another state.
    c. Swallow Fashions, Inc., owns a building that is destroyed by a hurricane. The adjusted basis is $250,000. Because of an economic downturn in the area caused by the closing of a military base, Swallow decides to rent space for its retail outlet rather than to replace the building. It uses all of the insurance proceeds of $300,000 to buy a four-unit apartment building in another city. A realtor in that city will handle the rental of the apartments.
    d. Susan and Rick's personal residence is destroyed by a tornado. They had owned it for 15 months. The adjusted basis was $170,000. Since they would like to travel, they decide not to acquire a replacement residence. Instead, they invest all of the insurance proceeds of $200,000 in a duplex, which they rent to tenants.

33. **LO.6** The City of Richmond is going to condemn some buildings to build a park. Steve's principal residence is among those to be condemned. His adjusted basis for the house and land is $120,000. The appraised value of the house and land is $104,000. Steve is unaware of the future condemnation proceedings, but would like his family to move to a better neighborhood. Therefore, when Ross, a realtor, mentions that he may have a corporate client who would like to purchase the property for $130,000, Steve is ecstatic and indicates a willingness to sell. **ETHICS AND EQUITY**

    Ross is having some "second thoughts" about his conversation with Steve. The potential corporate purchaser is a company owned by Ross and his wife. Ross is aware of the future condemnation proceedings. He considers himself a skilled negotiator and thinks he can negotiate a $260,000 price for the house. Ross is considering telling Steve that the corporate client has changed its mind. Ross would then indicate that he has learned the city will be condemning several buildings in order to create a park, but has not yet established the prices it will pay for the condemned property. He would also tell Steve that because he believes he can get more from the city than Steve would obtain, he is willing to gamble and purchase the property now from Steve for $130,000.

Ross will point out several benefits available to Steve. These include (1) not having to deal with the city, (2) receiving an amount that exceeds both the appraised value and the original purchase cost of the home, and (3) receiving the money now. While admitting that he could reap a substantial profit, Ross would emphasize that he would also be taking on substantial risks. In addition, Ross would explain that when he sells the property to the city, he will defer the taxes by reinvesting the sales proceeds (due to involuntary conversion).

Should Ross make a new proposal to Steve based on his "second thoughts"? How do you think Steve will respond?

34. **LO.6** Lark Corporation's office building is destroyed by a hurricane in September. The adjusted basis is $210,000. Lark receives insurance proceeds of $390,000 in October.
    a. Calculate Lark's realized gain or loss, recognized gain or loss, and basis for the replacement property if it acquires an office building for $390,000 in October.
    b. Calculate Lark's realized gain or loss, recognized gain or loss, and basis for the replacement property if it acquires a warehouse for $350,000 in October.
    c. Calculate Lark's realized gain or loss and recognized gain or loss if it does not acquire replacement property.

DECISION MAKING

35. **LO.6** Parkview, Inc.'s warehouse, which has an adjusted basis of $380,000 and a fair market value of $450,000, is condemned by an agency of the Federal government to make way for a highway interchange. The initial condemnation offer is $410,000. After substantial negotiations, the agency agrees to transfer to Parkview a surplus warehouse that it believes is worth $450,000. Parkview is a calendar year taxpayer. The condemnation and related asset transfer occurred during September 2010.
    a. What are the recognized gain or loss and the basis of the replacement warehouse if Parkview's objective is to recognize as much gain as possible?
    b. Advise Parkview regarding what it needs to do by what date in order to achieve its objective.

36. **LO.6** What are the *maximum* postponed gain or loss and the basis for the replacement property for the following involuntary conversions?

	Property	Type of Conversion	Amount Realized	Adjusted Basis	Amount Reinvested
a.	Drugstore (business)	Condemned	$160,000	$120,000	$100,000
b.	Apartments (investment)	Casualty	100,000	120,000	200,000
c.	Grocery store (business)	Casualty	400,000	300,000	350,000
d.	Residence (personal)	Casualty	16,000	18,000	17,000
e.	Vacant lot (investment)	Condemned	240,000	160,000	240,000
f.	Residence (personal)	Casualty	20,000	18,000	19,000
g.	Residence (personal)	Condemned	18,000	20,000	26,000
h.	Apartments (investment)	Condemned	150,000	100,000	200,000

CRITICAL THINKING

37. **LO.7** Milton, who is single, listed his personal residence with a real estate agent on March 3, 2010, at a price of $250,000. He rejected several offers in the $200,000 range during the summer. Finally, on August 16, 2010, he and the purchaser signed a contract to sell for $245,000. The sale (i.e., closing) took place on September 7, 2010. The closing statement showed the following disbursements:

Real estate agent's commission	$ 14,000
Appraisal fee	500
Exterminator's certificate	300
Recording fees	400
Mortgage to First Bank	180,000
Cash to seller	49,800

Milton's adjusted basis for the house is $150,000. He owned and occupied the house for eight years. On October 1, 2010, Milton purchases another residence for $210,000.

a. Calculate Milton's recognized gain on the sale.
b. What is Milton's adjusted basis for the new residence?
c. Assume instead that the selling price is $735,000. What is Milton's recognized gain? His adjusted basis for the new residence?

38. **LO.7** Jeff and Jill are divorced on August 1, 2010. According to the terms of the divorce decree, Jeff's ownership interest in the house is to be transferred to Jill in exchange for the release of marital rights. The house was separately owned by Jeff and on the date of the transfer has an adjusted basis of $175,000 and a fair market value of $200,000.

CRITICAL THINKING

DECISION MAKING

a. Does the transfer cause recognized gain to either Jeff or Jill?
b. What is the basis of the house to Jill?
c. If instead Jeff sold the house to Jill for $200,000 two months prior to the divorce, would either Jeff or Jill have recognized gain?
d. Which transaction, (a) or (c), would be preferable for Jeff?



1. In April of the current year, Blue Corporation purchased an asset to be used in its manufacturing operations for $100,000. Blue's management expects the asset to ratably provide valuable services in the production process for eight years and have a salvage value of $12,000. The asset is a five-year asset for tax purposes. Blue has adopted the half-year convention for book purposes in the year of acquisition and disposition; Blue uses MACRS for tax purposes.
   a. Compute the depreciation expense in the year of acquisition for book and tax purposes.
   b. Identify the book-tax difference related to the depreciation expense in the year of acquisition.

2. Refer to the facts in the preceding problem. Assume Blue Corporation disposes of the manufacturing asset at the beginning of year seven for $40,000. Compute the amount of gain or loss recognized for book and tax purposes. What is the book-tax difference in the year of disposition?

3. Identify whether the taxpayer's economic position has changed in the following exchanges such that they are subject to current taxation. That is, identify whether the following qualify as like-kind exchanges under § 1031.
   a. Improved for unimproved real estate.
   b. Vending machine (used in business) for inventory.
   c. Rental house for personal residence.
   d. Business equipment for securities.
   e. Warehouse for office building (both used for business).
   f. Truck for computer (both used in business).
   g. Rental house for land (both held for investment).
   h. Ten shares of stock in Blue Corporation for 10 shares of stock in Red Corporation.
   i. Office furniture for office equipment (both used in business).
   j. Unimproved land in Jackson, Mississippi, for unimproved land in Toledo, Spain.
   k. General partnership interest for a general partnership interest.

RESEARCH PROBLEMS

Note: Solutions to Research Problems can be prepared by using the **Checkpoint® Student Edition** online research product, which is available to accompany this text. It is also possible to prepare solutions to the Research Problems by using tax research materials found in a standard tax library.

THOMSON REUTERS
Checkpoint® Student Edition

Research Problem 1. As the result of a large inheritance from her grandmother, Marcy has a substantial investment portfolio. The securities are held in street name by her brokerage firm. Marcy's broker, Max, has standing oral instructions from her on sales transactions to sell the shares with the highest cost basis.

In October 2008, Marcy phoned Max and instructed him to sell 6,000 shares of Color, Inc. Her portfolio has 15,000 shares of Color, which were purchased in several transactions over a three-year period. At the end of each month, the brokerage firm provides Marcy

with a monthly statement that includes sales transactions. It does not identify the specific certificates transferred.

In filing her 2008 income tax return, Marcy used the specific identification method to calculate the $75,000 recognized gain on the sale. On audit of her 2008 return, the IRS has taken the position that under Reg. § 1.1012–1(c) Marcy should have used the FIFO method to report the sale of the Color shares, resulting in a gain of $140,000. According to this interpretation of the Regulations, Marcy may not use the specific identification method (and must use the FIFO method) because the broker did not provide written confirmation of Marcy's sales instructions.

Marcy has come to you for tax advice with respect to this issue.

Research Problem 2. Terry owns real estate with an adjusted basis of $600,000 and a fair market value of $1.1 million. The amount of the nonrecourse mortgage on the property is $2.5 million. Because of substantial past and projected future losses associated with the real estate development (occupancy rate of only 37% after three years), Terry deeds the property to the creditor.

a. What are the tax consequences to Terry?

b. Assume the data are the same, except the fair market value of the property is $2,525,000. Therefore, when Terry deeds the property to the creditor, she also receives $25,000 from the creditor. What are the tax consequences to Terry?

Research Problem 3. Taylor owns a 150-unit motel that was constructed in the late 1960s. It is located on 10 acres on the main highway leading into the city. Taylor renovated the motel three years ago.

Taylor's motel is condemned by the city, which is going to use 2 of the 10 acres for a small park. The other 8 acres are to be sold to a timeshare developer who intends to build 400 units on the property. The developer has already secured approval from the city planning commission.

Taylor's attorney advises him not to contest the condemnation of the 2 acres for the park. Under the eminent domain provision, the city does have the right to take "private property for public use." However, the attorney advises Taylor to contest the condemnation of the remaining property. According to the attorney, the city does not have the right to take "private property for private use."

The city's position is that the condemnation will result in a substantial number of new jobs and additional tax revenue for the city.

Will Taylor be successful if he follows the attorney's advice?



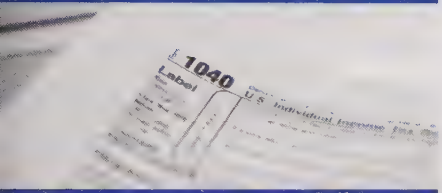
Use the tax resources of the Internet to address the following questions. Do not restrict your search to the Web, but include a review of newsgroups and general reference materials, practitioner sites and resources, primary sources of the tax law, chat rooms and discussion groups, and other opportunities.

Research Problem 4. The amount of the annual exclusion for gifts is indexed for inflation. This affects both the calculation of the gift tax liability and the donee's adjusted basis for the property received by gift for income tax purposes. The indexed amount for 2008 was $12,000, and the indexed amount for 2010 is $13,000. Find the latest estimate of the revenue loss for income tax purposes that the Treasury has attributed to indexing.

Research Problem 5. A number of public policy think tanks, taxpayer unions, and other private interest groups have proposed changes to the tax rules that apply to like-kind exchanges of realty. Summarize several of these proposals, including your assessment of the motivations underlying the suggested changes.

CHAPTER 8

Property Transactions: Capital Gains and Losses, Section 1231, and Recapture Provisions



TAX *Talk*

Governments likely to confiscate wealth are unlikely to find much wealth to confiscate in the long run.

—Thomas Sowell

LEARNING OBJECTIVES

After completing Chapter 8, you should be able to:

LO.1 Distinguish capital assets from ordinary assets. **(pp. 8-3 to 8-7)**

LO.2 Understand the relevance of a sale or exchange to classification as a capital gain or loss. **(pp. 8-7 to 8-13)**

LO.3 Determine the applicable holding period for a capital asset. **(pp. 8-13 to 8-16)**

LO.4 Describe the tax treatment of capital gains and losses for noncorporate taxpayers. **(pp. 8-16 to 8-24)**

LO.5 Describe the tax treatment of capital gains and losses for corporate taxpayers. **(pp. 8-24 to 8-25)**

LO.6 Distinguish § 1231 assets from ordinary and capital assets, and calculate § 1231 gain or loss. **(pp. 8-25 to 8-29)**

LO.7 Determine when recapture provisions apply and derive their effects. **(pp. 8-29 to 8-38)**

OUTLINE

8.1 General Considerations, 8-3
Rationale for Separate Reporting of Capital Gains and Losses, 8-3
General Scheme of Taxation, 8-3
8.2 Capital Assets, 8-3
Definition of a Capital Asset, 8-3
Statutory Expansions, 8-6
8.3 Sale or Exchange, 8-7
Worthless Securities and § 1244 Stock, 8-8
Retirement of Corporate Obligations, 8-8
Options, 8-8
Patents, 8-10
Franchises, Trademarks, and Trade Names, 8-11
Lease Cancellation Payments, 8-12
8.4 Holding Period, 8-13
Special Holding Period Rules, 8-13
Short Sales, 8-15
8.5 Tax Treatment of Capital Gains and Losses of Noncorporate Taxpayers, 8-16
Capital Gains, 8-16
Capital Losses, 8-19
Small Business Stock, 8-22
8.6 Tax Treatment of Capital Gains and Losses of Corporate Taxpayers, 8-24
8.7 Section 1231 Assets, 8-25
Relationship to Capital Assets, 8-25
Property Included, 8-25
Property Excluded, 8-26
Casualty or Theft and Nonpersonal-Use Capital Assets, 8-26
General Procedure for § 1231 Computation, 8-27
8.8 Section 1245 Recapture, 8-29
Section 1245 Property, 8-31
Observations on § 1245, 8-32
8.9 Section 1250 Recapture, 8-33
Unrecaptured § 1250 Gain (Real Estate 25% Gain), 8-33
Additional Recapture for Corporations, 8-35
8.10 Exceptions to §§ 1245 and 1250, 8-35
Gifts, 8-35
Death, 8-36
Charitable Transfers, 8-36
Certain Nontaxable Transactions, 8-37
Like-Kind Exchanges and Involuntary Conversions, 8-37
8.11 Reporting Procedures, 8-38
8.12 Summary, 8-38

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CAPITAL GAINS AND LOSSES, § 1231 GAINS AND LOSSES, AND RECAPTURE

Alice owns land that she received from her father 10 years ago as a gift. The land was purchased by her father in 1980 for $2,000 and was worth $10,000 at the time of the gift. The property is currently worth about $50,000. If Alice sells the land, you previously determined that she would have a taxable gain of $48,000.

Alice also owns 500 shares of stock, 300 of which were acquired as an inheritance when Alice's grandfather died in 1985. Alice's grandfather paid $12,000 for the shares, and the shares were worth $30,000 at the time of his death. If Alice sells those shares for $120 each, you previously determined that she would have a $6,000 taxable gain. The other 200 shares were purchased by Alice two months ago for $28,000. If Alice sells those shares for $120 each, you determined that she would have a recognized loss of $4,000.

Finally, Alice owns a house that she inherited from her grandmother two years ago. Based on the estate tax return, the fair market value of the house at the date of her grandmother's death was $475,000, and Alice will recognize a $125,000 gain on the sale of the property.

In addition, Alice's new husband sold depreciable equipment used in his sole proprietorship. The business purchased a $50,000 machine and deducted $35,000 of depreciation before selling it for $60,000.

Now Alice would like to know more about the gains and losses and the tax liability that she and her husband can expect from these transactions. **Read the chapter and formulate your response.**

8.1 General Considerations

RATIONALE FOR SEPARATE REPORTING OF CAPITAL GAINS AND LOSSES

Since the earliest days of the Federal income tax, **capital assets** have received special treatment upon their disposition. Gains from these assets have historically received *preferential treatment* in the form of either partial exclusion of gain, lower rates, or a maximum tax rate. Losses from capital assets, however, have historically received less desirable treatment than losses from other assets. Further, because a taxpayer has complete control over the timing of dispositions, the Code imposes limitations on when capital losses can be deducted to prevent taxpayers from manipulating their tax liability excessively.

During World War II, capital asset treatment was extended to other assets. These assets are now called "§ 1231 assets" after the Code Section that prescribes their special treatment. Several years after World War II ended, Congress believed that this special treatment was no longer entirely warranted. Instead of repealing § 1231, however, Congress left that section in place but eroded many—but not all—of its benefits through *recapture provisions* in § 1245 and § 1250. Together, these Code Sections constitute one of the most complicated areas of tax law affecting both individual taxpayers and business entities.

As already intimated, one concern is that taxpayers can time the realization of gains and losses by choosing when or even whether to sell the asset in question. If Lark Enterprises, Inc., owns stock with a basis of $20 per share and a current value of $80 per share, it does not pay tax on the $60 gain until it chooses to dispose of this stock in a taxable transaction. And for the most part, Lark has complete control over that decision. When it does dispose of the stock, however, its $60 gain is taxable in full, even though this gain may have accrued over many years. To mitigate the impact of this *bunching* of income in a single year and to offset the effect of inflation over the period of Lark's ownership of the stock, preferential treatment is prescribed for this **capital gain.**

The nature of this preferential treatment is discussed later in this chapter, but the essential point for now is that preferential treatment is confined to the excess of net long-term capital gains over net short-term **capital losses.** In addition, the tax law requires taxpayers to separate their capital asset transactions from their transactions involving noncapital assets. It further requires taxpayers to separate their long-term (i.e., more than one year) transactions from their short-term (i.e., one year or less) transactions. Moreover, certain types of capital assets (principally real estate and "collectibles") receive specific treatment apart from the rates generally applicable to capital assets.

GENERAL SCHEME OF TAXATION

Recognized gains and losses must be properly classified. Proper classification depends upon three characteristics.

- The tax status of the property, including the specific type of asset.
- The manner of the property's disposition.
- The holding period of the property.

The three possible tax statuses are capital asset, § 1231 asset, and ordinary asset. Property disposition may be by sale, exchange, casualty, theft, or condemnation. The two relevant holding periods are one year or less (short term) and more than one year (long term).

8.2 Capital Assets

LO.1

Distinguish capital assets from ordinary assets.

DEFINITION OF A CAPITAL ASSET

Investments comprise the most typical category of capital assets and include corporate stocks and bonds, mutual funds, partnership interests, government securities, and vacant land. These assets can be held by any type of taxpayer—individuals,

TAX in the NEWS

A Private Entity Becomes a Public Corporation

Until recently the New York Stock Exchange (NYSE) was not a corporation. Instead, it was a partnership owned by its members. Although a membership in the NYSE was a very valuable asset (in 2005 a membership was transferred for $3 million), the market for these memberships was limited. Transfer of a membership from one person to another had to be approved by the other members of the partnership, and that approval was sometimes hard to get. In 2006, the NYSE merged with Archipelago Holdings, Inc., a publicly traded corporation. The members of the NYSE partnership transferred their partnership interests for shares in Archipelago Holdings and, with proper tax planning, had no *recognized* gain on the transaction. After this transaction, anyone could own an interest in the NYSE by buying the shares of Archipelago. This transaction spawned many similar transactions involving other exchanges, including the Chicago Board of Trade. In addition, mergers and acquisitions of exchanges across the globe have become very common.

partnerships, limited liability companies, and corporations, whether closely held or publicly held. In addition, individuals own certain capital assets that are part of their daily life, such as residences, automobiles, furniture, and artwork. The classification of these *personal-use* assets as capital assets is relevant only when their disposition produces a recognized gain. Losses from the disposition of personal-use assets are not recognized for tax purposes, as explained in the preceding chapter. For businesses, goodwill is often the only capital asset.

Capital assets are not directly defined in the Code. Instead, § 1221(a) defines what is *not* a capital asset. A capital asset is property held by the taxpayer that is *not* any of the following.

- Inventory or property held primarily for sale to customers in the ordinary course of a business. The Supreme Court, in *Malat v. Riddell*,[1] defined *primarily* as meaning *of first importance* or *principally*.
- Accounts and notes receivable acquired from the sale of inventory or acquired for services rendered in the ordinary course of business.
- Depreciable property or real estate used in a business.
- Certain copyrights; literary, musical, or artistic compositions; or letters, memoranda, or similar property held by (1) a taxpayer whose efforts created the property; (2) in the case of a letter, memorandum, or similar property, a taxpayer for whom it was produced; or (3) a taxpayer who received the property as a lifetime gift from someone described in (1) or (2). When a sale or exchange involves musical compositions or copyrights in musical works either (1) created by the taxpayer's personal efforts or (2) having a basis determined by reference to the basis in the hands of a taxpayer whose personal efforts created the compositions or copyrights, the taxpayer may elect to treat the sale or exchange as the disposition of a capital asset.[2]
- U.S. government publications that are (1) received by a taxpayer from the U.S. government other than by purchase at the price at which they are offered for sale to the public or (2) held by a taxpayer who received the publication as a lifetime gift from someone described in (1).
- Supplies of a type regularly used or consumed in the ordinary course of a business.

Inventory

What constitutes inventory is determined by reference to the taxpayer's business.

EXAMPLE 1

Green Company buys and sells used cars. Its cars are inventory. Its gains from the sale of the cars are ordinary income. ■

[1] 66-1 USTC ¶9317, 17 AFTR 2d 604, 86 S.Ct. 1030 (USSC, 1966).

[2] § 1221(b)(3).

Soong sells her personal-use automobile at a $500 gain. The automobile is a personal-use asset and, therefore, a capital asset. The gain is a capital gain. ■

No asset is inherently capital or ordinary. If Soong in Example 2 sells her capital asset automobile to Green Company in Example 1, that very same automobile loses its capital asset status, because it is inventory to Green Company. Similar transformations can occur if, for example, an art dealer sells a painting (inventory; *not* a capital asset) to a private collector (now a capital asset). Whether an asset is capital or ordinary, therefore, depends entirely on the relationship of *that asset* to the taxpayer who sold it. This classification dilemma is but one feature of capital asset treatment that makes this area so confusing and perennially complicated.

Accounts and Notes Receivable

Collection of an accrual basis account receivable usually does not result in a gain or loss because the amount collected equals the receivable's basis. The *sale* of an account or note receivable may generate a gain or loss, however, because it will probably be sold for more or less than its basis. That gain or loss will be ordinary because the receivable is not a capital asset. A cash basis account receivable has no basis, so sale of such a receivable generates a gain, and that gain is ordinary income. Collection of a cash basis receivable also generates ordinary income.

Oriole Company, an accrual basis taxpayer, has accounts receivable of $100,000. Revenue of $100,000 was recorded and a $100,000 basis was established when the receivable was created. Because Oriole needs working capital, it sells the receivables for $83,000 to a financial institution. Accordingly, it has a $17,000 ordinary loss. If Oriole is a cash basis taxpayer, it has $83,000 of ordinary income because it would not have recorded any revenue earlier and the receivable would have no tax basis. ■

Business Fixed Assets

Depreciable personal property and real estate (both depreciable and nondepreciable) used by a business are not capital assets. Thus, *business fixed assets* are not capital assets. Business fixed assets can sometimes be treated as capital assets pursuant to § 1231, however, as discussed later in this chapter.

Copyrights and Creative Works

Generally, the person whose efforts led to the copyright or creative work has an ordinary asset, not a capital asset. This rule makes the creator comparable to a taxpayer whose customary activity (salary, business profits) is taxed as ordinary income. *Creative works* include the works of authors, composers, and artists. Also, the person for whom a letter, memorandum, or other similar property was created has an ordinary asset. Finally, a person receiving a copyright, creative work, letter, memorandum, or similar property by lifetime gift from the creator or the person for whom the work was created also has an ordinary asset. Note the exception mentioned earlier that permits the taxpayer to elect to treat the sale or exchange of a musical composition or a copyright of a musical work as the disposition of a capital asset.

Wanda is a part-time music composer. A music publisher purchases one of her songs for $5,000. Wanda has a $5,000 ordinary gain from the sale of an ordinary asset unless she elects to treat the gain as a capital gain. ■

Ed received a letter from the President of the United States in 1994. In the current year, Ed sells the letter to a collector for $300. Ed has a $300 ordinary gain from the sale of an ordinary asset (because the letter was created for Ed). ■

Isabella gives a song she composed to her son. Her son sells the song to a music publisher for $5,000. Her son has a $5,000 ordinary gain from the sale of an ordinary asset

unless he elects to treat the gain as a capital gain. If he inherits the song from Isabella, his basis for the song is its fair market value at Isabella's death. In this situation, the song is a capital asset because the son's basis is not related to Isabella's basis for the song (i.e., the song was not a *lifetime* gift). ■

U.S. Government Publications

U.S. government publications received from the U.S. government (or its agencies) for a reduced price (i.e., below that at which it is available to the general public) are not capital assets. This prevents a taxpayer from later donating the publications to charity and claiming a charitable contribution deduction equal to the fair market value of the publications. A charitable contribution of a capital asset generally yields a deduction equal to the asset's fair market value. If such property is received by gift from the original purchaser, the property is not a capital asset to the donee. (For a more comprehensive explanation of charitable contributions of property, refer to Chapter 5.)



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STATUTORY EXPANSIONS

Because of the uncertainty often associated with capital asset status, Congress has occasionally enacted Code Sections to clarify the definition in particular circumstances. These statutory expansions of the capital asset definition are discussed in this section.

Dealers in Securities

As a general rule, securities (stocks, bonds, and other financial instruments) held by a dealer are considered to be inventory and are, therefore, not subject to capital gain or loss treatment. A *dealer in securities* is a merchant (e.g., a brokerage firm) that regularly engages in the purchase and resale of securities to customers. However, under the following circumstances, a dealer will have capital gain or capital loss. If a dealer clearly identifies certain securities as held for investment purposes by the close of business on the acquisition date, gain from the securities' sale will be capital gain. The gain will be ordinary if the dealer ceases to hold the securities for investment prior to the sale. Losses are capital losses if at any time the securities have been clearly identified by the dealer as held for investment.[3]



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Real Property Subdivided for Sale

Substantial real property development activities may result in the owner being considered a dealer for tax purposes. If so, income from the sale of real estate property lots will be treated as the sale of inventory and therefore will be taxed as ordinary income. However, § 1237 allows real estate investors to claim capital gain treatment if they engage *only* in *limited* development activities. To be eligible for § 1237 treatment, the following requirements must be met.

- The taxpayer is not a corporation.
- The taxpayer is not a real estate dealer.
- No substantial improvements have been made to the lots sold. *Substantial* generally means more than a 10 percent increase in the value of a lot. Shopping centers and other commercial or residential buildings are considered substantial, while filling, draining, leveling, and clearing operations are not.

[3] §§ 1236(a) and (b) and Reg. §§ 1.1236–1(a) and (b).

TAX in the NEWS

Losses on Subprime Mortgages

During 2009, many banks and other financial institutions took huge financial accounting write-downs on securities that consisted of "bundles" of subprime mortgages. (Subprime mortgages are loans made to homeowners with weak credit.) If the financial institution holds these securities as investments, they are capital assets. If the financial institution holds these securities as inventory, they are ordinary assets. However, writing them down for financial accounting purposes does not mean that the institution actually disposed of the securities. Therefore, the loss in value of the securities will not be recognized for tax purposes until the securities are transferred in a sale or exchange.

- The taxpayer has held the lots sold for at least 5 years, except for inherited property. The substantial improvements test is less stringent if the property is held at least 10 years.

If the preceding requirements are met, all gain is capital gain until the taxable year in which the *sixth* lot is sold. Sales of contiguous lots to a single buyer in the same transaction count as the sale of one lot. Beginning with the taxable year in which the *sixth* lot is sold, 5 percent of the revenue from lot sales is potential ordinary income. That potential ordinary income is offset by any selling expenses from the lot sales. Practically, sales commissions often are at least 5 percent of the sales price, so usually none of the gain is treated as ordinary income.

Section 1237 does not apply to losses. A loss from the sale of subdivided real property is ordinary loss unless the property qualifies as a capital asset under § 1221. The following example illustrates the application of § 1237.

EXAMPLE 7

Ahmed owns a large tract of land and subdivides it for sale. Assume Ahmed meets all the requirements of § 1237 and during the tax year sells the first 10 lots to 10 different buyers for $10,000 each. Ahmed's basis in each lot sold is $3,000, and he incurs total selling expenses of $4,000 on the sales. Ahmed's gain is computed as follows.

Selling price (10 × $10,000)	$100,000	
Less: Selling expenses (10 × $400)	(4,000)	
Amount realized		$ 96,000
Basis (10 × $3,000)		(30,000)
Realized and recognized gain		$ 66,000
Classification of recognized gain:		
Ordinary income		
Five percent of selling price (5% × $100,000)	$ 5,000	
Less: Selling expenses	(4,000)	
Ordinary gain		1,000
Capital gain		$ 65,000

■

8.3 Sale or Exchange

LO.2

Understand the relevance of a sale or exchange to classification as a capital gain or loss.

Recognition of capital gain or loss usually requires a **sale or exchange** of a capital asset. The Code uses the term *sale or exchange*, but does not define it. Generally, a property sale involves the receipt of money by the seller and/or the assumption by the purchaser of the seller's liabilities. An exchange involves the transfer of property for other property. Thus, an involuntary conversion (casualty, theft, or condemnation) is not a sale or exchange. In several situations, the determination of whether or when a sale or exchange has taken place has been clarified by the enactment of Code Sections that specifically provide for sale or exchange treatment. These situations are discussed below.

Recognized gains or losses from the cancellation, lapse, expiration, or any other termination of a right or obligation with respect to personal property (other than

TAX in the NEWS

Bankruptcy and Worthless Stock

During 2009, General Motors went into bankruptcy, was reorganized, and emerged from bankruptcy. However, the common shareholders of the General Motors that went into bankruptcy were not the common shareholders of the General Motors that emerged from bankruptcy. The original common shareholders lost their entire investment because their stock became worthless. The holding period of their stock ended for tax purposes on December 31, 2009, because of the worthless stock rules. They had a capital loss equal to whatever their basis was for the worthless shares. The debtors of General Motors accepted common shares in the General Motors that emerged from bankruptcy. Generally, the exchange of debt for common shares in a bankruptcy reorganization is not a taxable transaction, and the basis of the debt becomes the basis for the shares.

stock) that is or would be a capital asset in the hands of the taxpayer are capital gains or losses.[4] See the discussion under Options later in the chapter for more details.

WORTHLESS SECURITIES AND § 1244 STOCK

Occasionally, securities such as stock and bonds may become worthless due to the insolvency of their issuer. If the security is a capital asset, the loss is deemed to have occurred as the result of a sale or exchange on the *last day* of the tax year.[5] This last-day rule may have the effect of converting a short-term capital loss into a long-term capital loss. (See Capital Losses later in this chapter.) Worthless securities are discussed in Chapter 6.

Section 1244 allows an *ordinary* deduction on disposition of stock at a loss. The stock must be that of a small business corporation, and the ordinary deduction is limited to $50,000 ($100,000 for married individuals filing jointly) per year.

RETIREMENT OF CORPORATE OBLIGATIONS

A debt obligation (e.g., a bond or note payable) may have a tax basis different from its redemption value because it may have been acquired at a premium or discount. Consequently, the collection of the redemption value may result in a loss or a gain. Generally, the collection of a debt obligation is *treated* as a sale or exchange.[6] Therefore, any loss or gain is capital because a sale or exchange has taken place.

DIGGING DEEPER 3

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EXAMPLE 8

Osprey, Inc., purchases $1,000 of Golden Eagle Corporation bonds for $1,020 in the open market. If the bonds are held to maturity, and the bond premium is not amortized, the $20 difference between Osprey's collection of the $1,000 redemption value and its cost of $1,020 is treated as capital loss. ■

OPTIONS

Frequently, a potential buyer of property wants to defer a final purchase decision, but wants to control the sale and/or the sale price in the meantime. **Options** are used to achieve such control. The potential purchaser (grantee) pays the property owner (grantor) for an option on the property. The grantee then becomes the option holder. An option usually sets the price at which a grantee can buy the property and expires after a specified period of time.

[4] § 1234A.
[5] § 165(g)(1).
[6] § 1271.



CONCEPT SUMMARY 8.1

Options

Event	Effect on Grantor	Effect on Grantee
Option is granted.	Receives value and has a contract obligation (a liability).	Pays value and has a contract right (an asset).
Option expires.	Has a short-term capital gain if the option property is stocks, securities, commodities, or commodity futures. Otherwise, gain is ordinary income.	Has a loss (capital loss if option property would have been a capital asset for the grantee). Otherwise, loss is ordinary.
Option is exercised.	Amount received for option increases proceeds from sale of the option property.	Amount paid for option becomes part of the basis of the option property purchased.
Option is sold or exchanged by grantee.	Result depends upon whether option later expires or is exercised (see above).	Could have gain or loss (capital gain or loss if option property would have been a capital asset for the grantee).

Sale of an Option

In addition to exercising an option or letting it expire, a grantee can often arrange for its sale or exchange. Such a sale or exchange generally results in capital gain or loss if the option property is (or would be) a capital asset to the grantee.[7]

EXAMPLE 9

Robin & Associates wants to buy some vacant land for investment purposes, but cannot afford the full purchase price. Instead, the firm convinces the landowner (grantor) to sell it the right to purchase the land for $100,000 anytime in the next two years. Robin & Associates (grantee) pays $3,000 for this option to buy the land. The option is a capital asset to Robin because if the firm actually purchased the land (the option property), the land would be a capital asset. Three months after purchasing the option, Robin sells it for $7,000. The firm has a $4,000 ($7,000 − $3,000) capital gain on this sale. ■

Failure to Exercise Options

If an option holder (grantee) fails to exercise the option, the lapse of the option is considered a sale or exchange on the option expiration date. Thus, the resulting loss is a capital loss if the property subject to the option is (or would be) a capital asset in the hands of the grantee.

The grantor of an option on *stocks, securities, commodities, or commodity futures* receives short-term capital gain treatment upon the expiration of the option.[8] For example, an individual investor who owns stock (a capital asset) may sell a call option, entitling the buyer of the option to acquire the stock at a specified price higher than the stock's value at the date the option is granted. The writer of the call (the grantor) receives a premium for writing the option. If the price of the stock does not increase during the option period, the option will expire unexercised. Upon the expiration of the option, the grantor must recognize a short-term capital gain equal to the premium received. These provisions do not apply to options held for sale to customers (the inventory of a securities dealer).

Options on property *other than* stocks, securities, commodities, or commodity futures result in ordinary income to the grantor when the option expires. For instance, the landowner in the preceding example would have ordinary income of $3,000 if Robin (the grantee) had allowed the option to expire.

[7] § 1234(a) and Reg. § 1.1234–1(a)(1).

[8] § 1234(b)(1).

Exercise of Options by Grantee

If an option is exercised, the amount paid for the option is added to the optioned property's selling price. This increases the gain (or reduces the loss) to the grantor resulting from the sale of the property. The grantor's gain or loss is capital or ordinary depending on the tax status of the property. The grantee adds the cost of the option to the basis of the property purchased.

EXAMPLE 8

Several years ago, Indigo, Inc., purchased 100 shares of Eagle Company stock for $5,000. On April 1 of this year, Indigo writes a call option on the stock, giving the grantee the right to buy the stock for $6,000 during the following six-month period. Indigo (the grantor) receives a call premium of $500 for writing the call.

- If the call is exercised by the grantee on August 1, Indigo has $1,500 ($6,000 + $500 − $5,000) of long-term capital gain from the sale of the stock. The grantee has a $6,500 ($500 option premium + $6,000 purchase price) basis for the stock.
- Assume that the option expired unexercised. Indigo has a $500 short-term capital gain equal to the call premium received for writing the option. This gain is not recognized until the option expires. The grantee has a loss from expiration of the option. The nature of that loss will depend upon whether the option was a capital asset or an ordinary asset in the hands of the grantee. ■

PATENTS

Transfer of a **patent** is treated as the sale or exchange of a long-term capital asset when *all substantial rights* to the patent (or an undivided interest that includes all such rights) are transferred by a *holder*.[9] The transferor/holder may receive payment in virtually any form. Lump-sum or periodic payments are most common. The amount of the payments may also be contingent on the transferee/purchaser's productivity, use, or disposition of the patent. If the transfer meets these requirements, any gain or loss is *automatically a long-term* capital gain or loss. Whether the asset was a capital asset for the transferor, whether a sale or exchange occurred, and how long the transferor held the patent are all irrelevant.

EXAMPLE 9

Mei-Yen, a druggist, invents a pill-counting machine, which she patents. In consideration of a lump-sum payment of $200,000 plus $10 per machine sold, Mei-Yen assigns the patent to Drug Products, Inc. Assuming Mei-Yen has transferred all substantial rights, she automatically has a long-term capital gain from both the lump-sum payment and the $10 per machine royalty to the extent these proceeds exceed her basis for the patent. ■

This special long-term capital gain or loss treatment for patents is intended to encourage technological development and scientific progress. In contrast, books, songs, and artists' works may be copyrighted, but copyrights and the assets they represent are not capital assets. Thus, the disposition of these assets by their creators usually results in ordinary gain or loss.

Substantial Rights

To receive favorable capital gain treatment, all *substantial rights* to the patent (or an undivided interest in it) must be transferred. All substantial rights to a patent means all rights that are valuable at the time the patent rights (or an undivided interest in the patent) are transferred. All substantial rights have not been transferred when the transfer is limited geographically within the issuing country or when the transfer is for a period less than the remaining legal life of the patent. The circumstances of the entire transaction, rather than merely the language used in the transfer instrument, are to be considered in deciding whether all substantial rights have been transferred.[10]

[9] § 1235.

[10] Reg. § 1.1235–2(b)(1).

EXAMPLE 11

Assume Mei-Yen, the druggist in the preceding example, only licensed Drug Products, Inc., to manufacture and sell the invention in Michigan. She retained the right to license the machine elsewhere in the United States. Mei-Yen has retained a substantial right and is not eligible for automatic long-term capital gain treatment. ■

Holder Defined

The *holder* of a patent must be an *individual* and is usually the invention's creator. A holder may also be an individual who purchases the patent rights from the creator before the patented invention has been reduced to practice. However, the creator's employer and certain parties related to the creator do not qualify as holders. Thus, in the common situation where an employer has all rights to an employee's inventions, the employer is not eligible for long-term capital gain treatment. More than likely, the employer will have an ordinary asset because the patent was developed as part of its business.

FRANCHISES, TRADEMARKS, AND TRADE NAMES

A mode of operation, a widely recognized brand name (trade name), and a widely known business symbol (trademark) are all valuable assets. These assets may be licensed (commonly known as *franchising*) by their owner for use by other businesses. Many fast-food restaurants (such as McDonald's and Taco Bell) are franchises. The franchisee usually pays the owner (franchisor) an initial fee plus a contingent fee. The contingent fee is often based upon the franchisee's sales volume.

For Federal income tax purposes, a **franchise** is an agreement that gives the franchisee the right to distribute, sell, or provide goods, services, or facilities within a specified area.[11] A franchise transfer includes the grant of a franchise, a transfer by one franchisee to another person, or the renewal of a franchise.

Section 1253 provides that a transfer of a franchise, trademark, or trade name is *not* a sale or exchange of a capital asset when the transferor retains any significant power, right, or continuing interest in the property transferred.

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Significant Power, Right, or Continuing Interest

Significant powers, rights, or continuing interests include control over assignment of the franchise, trademark, or trade name, as well as the quality of the transferee's products or services. The following rights also are included.

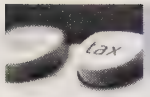
- Right to require the transferee to sell or advertise *only* the transferor's products or services.
- Right to require the transferee to purchase substantially all supplies and equipment from the transferor.
- Right to receive substantial contingent payments.
- Right to terminate the franchise, trademark, or trade name at will.

In the unusual case where no significant power, right, or continuing interest is retained by the transferor, a sale or exchange may occur, and capital gain or loss treatment may be available. For capital gain or loss treatment to be available, the asset transferred must still qualify as a capital asset.

EXAMPLE 12

Orange, Inc., a franchisee, sells the franchise to a third party. Payments to Orange are not contingent, and all significant powers, rights, and continuing interests are transferred. The gain (payments − adjusted basis) on the sale is a capital gain to Orange. ■

[11] § 1253(b)(1).



CONCEPT SUMMARY 8.2

Franchises

Event	Effect on Franchisor	Effect on Franchisee
Franchisor Retains Significant Powers and Rights		
Noncontingent payment	Ordinary income.	Capitalized and amortized over 15 years as an ordinary deduction; if franchise is sold, amortization is subject to recapture under § 1245.
Contingent payment	Ordinary income.	Ordinary deduction.
Franchisor Does *Not* Retain Significant Powers and Rights		
Noncontingent payment	Ordinary income if franchise rights are an ordinary asset; capital gain if franchise rights are a capital asset (unlikely).	Capitalized and amortized over 15 years as an ordinary deduction; if the franchise is sold, amortization is subject to recapture under § 1245.
Contingent payment	Ordinary income.	Ordinary deduction.

Noncontingent Payments

When the transferor retains a significant power, right, or continuing interest, the transferee's noncontingent payments to the transferor are ordinary income to the transferor. The franchisee capitalizes the payments and amortizes them over 15 years. The amortization is subject to recapture under § 1245, discussed later in this chapter.

EXAMPLE 14

Grey Company signs a 10-year franchise agreement with DOH Donuts. Grey (the franchisee) makes payments of $3,000 per year for the first 8 years of the franchise agreement—a total of $24,000. Grey cannot deduct $3,000 per year as the payments are made. Instead, Grey must amortize the $24,000 total over 15 years. Thus, Grey may deduct $1,600 per year for each of the 15 years of the amortization period. The same result would occur if Grey had made a $24,000 lump-sum payment at the beginning of the franchise period. Assuming DOH Donuts (the franchisor) retains significant powers, rights, or a continuing interest, it will have ordinary income when it receives the payments from Grey. ■

Contingent Payments

Whether or not the transferor retains a significant power, right, or continuing interest, contingent franchise payments are ordinary income for the franchisor and an ordinary deduction for the franchisee.

EXAMPLE 15

TAK, a spicy chicken franchisor, transfers an eight-year franchise to Egret Corporation. TAK retains a significant power, right, or continuing interest. Egret, the franchisee, agrees to pay TAK 15% of sales. This contingent payment is ordinary income to TAK and a business deduction for Egret as the payments are made. ■

LEASE CANCELLATION PAYMENTS

The tax treatment of payments received for canceling a lease depends on whether the recipient of the payments is the **lessor** or the **lessee** and whether the lease is a capital asset or not.

Lessee Treatment

Lease cancellation payments received by a lessee (the tenant) are treated as an exchange.[12] Thus, these payments are capital gains if the lease is a capital asset. Generally, a lessee's lease is a capital asset if the property (either personalty or realty) is used for the lessee's personal use (e.g., his or her residence). A lease held one year or less is an ordinary income asset if the property is used in the lessee's trade or business.[13]

EXAMPLE 16

Merganser, Inc., owns an apartment building that it is going to convert into an office building. Vicki is one of the apartment tenants who receives $1,000 from Merganser to cancel the lease. Vicki has a capital gain of $1,000 (which is long term or short term depending upon how long she has held the lease). Merganser has an ordinary deduction of $1,000. ■

Lessor Treatment

Payments received by a lessor (the landlord) for a lease cancellation are always ordinary income because they are considered to be in lieu of rental payments.[14]

EXAMPLE 17

Finch & Company owns an apartment building near a university campus. Hui-Fen is one of the tenants. Hui-Fen is graduating early and offers Finch $800 to cancel the apartment lease. Finch accepts the offer. Finch has ordinary income of $800. Hui-Fen has a nondeductible payment since the apartment was personal-use property. ■

8.4 Holding Period

LO.3

Determine the applicable holding period for a capital asset.

Property must be held more than one year to qualify for long-term capital gain or loss treatment.[15] Property not held for the required long-term period results in short-term capital gain or loss. To compute the **holding period**, start counting on the day after the property was acquired and include the day of disposition.

EXAMPLE 18

Mallard & Co. purchases a capital asset on January 15, 2009, and sells it on January 16, 2010. Mallard's holding period is more than one year. If Mallard had sold the asset on January 15, 2010, the holding period would have been exactly one year, and the gain or loss would have been short term. ■

To be held for more than one year, a capital asset acquired on the last day of any month must not be disposed of until on or after the first day of the thirteenth succeeding month.[16]

EXAMPLE 19

Purple, Inc., purchases a capital asset on March 31, 2009. If Purple sells the asset on March 31, 2010, the holding period is one year, and Purple will have a short-term capital gain or loss. If Purple sells the asset on April 1, 2010, the holding period is more than one year, and it will have a long-term capital gain or loss. ■

SPECIAL HOLDING PERIOD RULES

There are several special holding period rules.[17] The application of these rules depends on the type of asset and how it was acquired.

Nontaxable Exchanges

The holding period of property received in a like-kind exchange (and certain other qualified nontaxable exchanges) includes the holding period of the former asset if the property that was exchanged was either a capital asset or a § 1231 asset.

[12] § 1241 and Reg. § 1.1241–1(a).

[13] Reg. § 1.1221–1(b), PLR 200045019. If the lease was held for more than one year before cancellation, it is a § 1231 asset.

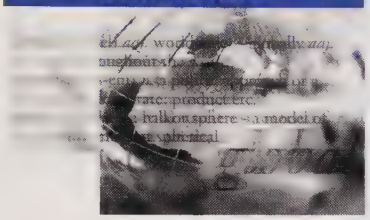
[14] Reg. § 1.61–8(b).

[15] § 1222(3).

[16] Rev.Rul. 66–7, 1966–1 C.B. 188.

[17] § 1223.

GLOBAL Tax Issues



Trading ADRs on U.S. Stock Exchanges

Many non-U.S. companies now have subsidiaries that were formerly U.S. companies. For instance, until 2007 Chrysler Corporation was a subsidiary of DaimlerChrysler (formed when the German company Daimler-Benz acquired Chrysler). Shares in such non-U.S. companies generally cannot be traded directly on U.S. stock exchanges. Instead, the offshore companies issue instruments called American Depository Receipts (ADRs) that can be traded on U.S. stock exchanges. Purchases and sales of ADRs are treated for tax purposes as though the ADRs were shares in the corporation that issued them.

EXAMPLE 29

Red Manufacturing Corporation exchanges some vacant real estate it owns (a capital asset) for land closer to its factory. The transaction is a like-kind exchange, so the holding period of the new land includes the holding period of the old land. ■

EXAMPLE 30

A lightning strike destroyed Vireo Company's generator (a § 1231 asset) in March. Vireo uses the entire insurance proceeds it received to acquire a comparable generator. The holding period of the new generator includes the holding period of the old generator because this is a nontaxable involuntary conversion. ■

Nontaxable Transactions Involving Carryover of Another Taxpayer's Basis

If a transaction is nontaxable and the former owner's basis carries over to the present owner, the former owner's holding period is included in (tacked on to) the present owner's holding period.

EXAMPLE 31

Kareem acquired 100 shares of Robin Corporation stock for $1,000 on December 31, 2006. He transferred the shares by gift to Megan on December 31, 2009, when the stock was worth $2,000. Kareem's basis of $1,000 becomes the basis for determining gain or loss on a subsequent sale by Megan. Megan's holding period begins with the date the stock was acquired by Kareem. ■

EXAMPLE 32

Assume the same facts as in the preceding example, except that the fair market value of the shares was only $800 on the date of the gift. If Megan sells the stock for a loss, its value at the date of the gift is her basis. Accordingly, the tacked-on holding period rule does not apply, and Megan's holding period begins with the date of the gift. So, if she sells the shares for $500 on April 1, 2010, Megan has a $300 recognized capital loss, and the holding period is from December 31, 2009, to April 1, 2010. The loss is short term. ■

Disallowed Loss Transactions

Under several Code provisions, realized losses are disallowed. When a loss is disallowed, there is no carryover of holding period. Losses can be disallowed under § 267 (sale or exchange between related taxpayers) and § 262 (sale or exchange of personal-use assets) as well as other Code Sections. Taxpayers who acquire property in a disallowed loss transaction begin a new holding period and have a basis equal to the purchase price.

EXAMPLE 33

Janet sells her personal automobile at a loss. She may not deduct the loss because it arises from the sale of personal-use property. Janet purchases a replacement automobile for more than the selling price of her former automobile. Janet has a basis equal to the cost of the replacement automobile, and her holding period begins when she acquires the replacement automobile. ■

Inherited Property

The holding period for inherited property is treated as long term no matter how long the property is actually held by the heir. The holding period of the decedent or the decedent's estate is not relevant to the heir's holding period.

EXAMPLE 25

Shonda inherits Blue Company stock from her father. She receives the stock on April 1, 2010, and sells it on November 1, 2010. Even though Shonda did not hold the stock more than one year, she receives long-term capital gain or loss treatment on the sale. ■

SHORT SALES

A **short sale** occurs when a taxpayer sells borrowed property and repays the lender with substantially identical property either held on the date of the sale or purchased after the sale. Short sales typically involve corporate stock. The seller's objective is to make a profit in anticipation of a decline in the stock's price. If the price declines, the seller in a short sale recognizes a profit equal to the difference between the sales price of the borrowed stock and the price paid for its replacement.

Section 1233 provides that a short sale gain or loss is a capital gain or loss to the extent that the short sale property constitutes a capital asset of the taxpayer. This gain or loss is not recognized until the short sale is closed. Generally, the holding period of the short sale property is determined by how long the property used to close the short sale was held.

EXAMPLE 26

On January 4, Green & Associates sold short 100 shares of Osprey Corporation for $1,500. Green closed the transaction on July 28 of the same year by purchasing 100 shares of Osprey for $1,000 and delivering them to the broker from whom the securities were borrowed. Because this stock was held less than one year (actually less than a day), Green's gain ($1,500 sale price − $1,000 cost) is short term. ■

EXAMPLE 27

Assume the same facts as in the preceding example, except that the January 4 short sale was not closed until January 28 of the *following* year. The result is the same, because the stock was acquired and used to close the transaction on the same day; that is, it was not held more than a year. ■

If a taxpayer owns securities that are "substantially identical" to those sold short, § 1259 subjects the short sale to potential *constructive sale treatment*, and the taxpayer recognizes gain (but not loss) as of that date. If the taxpayer has not closed the short sale by delivering the short sale securities to the broker from whom the securities were borrowed before January 31 of the year following the short sale, the short sale is deemed to have closed on the short sale date. The holding period in such circumstances is determined by how long the securities in question were held.

EXAMPLE 28

Assume the same facts as in Example 26, except that Green & Associates owned 100 shares of Osprey Corporation when it sold short 100 shares on January 4. Green does not close the short sale before January 31 of the following year. Green must recognize any gain on its 100 shares of Osprey as of January 4 of the current year. If Green owned those shares more than one year as of that date, the gain is long term. ■

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.



Tax Planning Strategies TIMING CAPITAL GAINS

FRAMEWORK FOCUS: INCOME AND EXCLUSIONS

Strategy: Postpone Recognition of Income to Achieve Tax Deferral.

FRAMEWORK FOCUS: DEDUCTIONS

Strategy: Maximize Deductible Amounts.

Taxpayers have considerable control over the timing of their capital gains through the mechanism of realization. Accordingly, a taxpayer might want to defer recognizing a large capital gain in a year with *substantial itemized deductions*, such as large personal casualty losses or miscellaneous itemized deductions. In so doing, the taxpayer minimizes the loss of such deductions due to AGI limitations.

Nontax considerations, of course, often dictate when assets are sold. If a particular stock is peaking in popularity, selling it might be a wise investment strategy, even if the taxpayer's current tax situation is not optimal. Similarly, if a taxpayer needs cash to start a business, purchase a home, or pay for a child's education or medical costs, the capital asset might need to be sold at a time when investment *and* tax considerations counsel otherwise. In these circumstances, however, a taxpayer might choose to *borrow* the money required and use the capital asset as collateral for the loan, rather than sell the asset. A loan does not trigger tax consequences, and the taxpayer can continue to hold the asset until a more opportune time—albeit at the cost of paying interest, which may be nondeductible.

8.5 TAX TREATMENT OF CAPITAL GAINS AND LOSSES OF NONCORPORATE TAXPAYERS

LO.4

Describe the tax treatment of capital gains and losses for noncorporate taxpayers.

This section discusses how capital gains and losses are taxed to noncorporate taxpayers, that is, individuals, noncorporate partners, trusts, and estates. The rules applicable to corporations are considered in the following section of this chapter.

CAPITAL GAINS

Gains from the sale or exchange of capital assets are taxed at various rates, depending upon the holding period, the taxpayer's regular tax rate, and the type of asset involved.

Short-Term Gains

Gains on capital assets held one year or less are taxed as *ordinary income*. Accordingly, the applicable tax rates vary from 10 percent to 35 percent. Although short-term capital gains receive no preferential tax treatment compared to ordinary income, they do have one advantage: they can absorb capital losses without limit. As discussed later in this section, *capital losses* are deducted first against capital gains (without limit) and then against ordinary income, but only up to $3,000 per year.[18] Thus, someone with a large capital loss will find short-term capital gains attractive, even though such gains do not qualify for lower tax rates.

Long-Term Gains

Gains on capital assets held more than one year are classified as *long-term* gains and are eligible for a special 15 percent tax rate, or 0 percent rate for taxpayers in the 10 or 15 percent tax bracket. (For tax years before 2008, the 0 percent alternative rate was 5 percent.) The benefit of these long-term capital gain tax rates, therefore, is as follows.

[18] § 1211(b).

Individual Returns Reporting Capital Gains

The number of individual income tax returns including net capital gain in AGI is shown in the table below. Over 138 million individual returns are filed annually, so based on the most current data about 19.3 percent of all returns report capital gain income. During the stock market boom of the late 1990s, though, this percentage was higher. Nonetheless, after the turn of the century, reduced capital gain tax rates likely have contributed to higher dollar amounts of net capital gains than ever. In fact, the amount of net capital gains reported in the most recent year increased by 16.7 percent over the previous year.

Year	Number of Returns (in Millions)
1975	5.8
1980	7.0
1985	10.0
1990	9.2
1995	14.8
2000	22.7
2003	22.9
2006	26.7

Source: Adapted from Justin Bryan, "Individual Income Tax Returns, 2006," *SOI Bulletin*, Fall 2008, Figure B.

Beneficial Tax Rates

Tax Rates		Differential
Ordinary Income	Capital Gain	(Percentage Points)
10%	0%	10
15	0	15
25	15	10
28	15	13
33	15	18
35	15	20

Tax Planning Strategies Gifts of Appreciated Securities

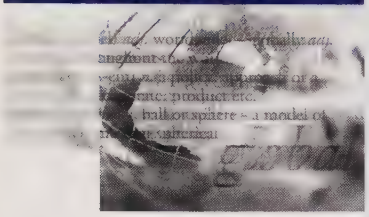
FRAMEWORK FOCUS: TAX RATE

Strategy: Shift Net Income from High-Bracket Taxpayers to Low-Bracket Taxpayers.

Persons with appreciated securities that have been held over one year may reduce the tax due on their sale by giving the securities to someone (often a child) who is in the *lowest tax bracket*. The donor's holding period carries over, along with his or her basis, and the donee's lower tax rate applies when the securities are sold. As a result, the gain could be taxed at the donee's 0 percent, rather than the donor's 15 percent. The donee should be at least age 19 (or 24 in the case of a full-time student) by year-end, however, or the *kiddie tax* will nullify most of the tax advantage being sought. The kiddie tax subjects the gain to the parents' tax rate. See Chapter 16.

Such gifts usually bear no gift tax due to the annual $13,000 exclusion. But the property received after payment of the tax belongs to the donee. It is not available to the donor, nor may it be used to pay a parent's essential support obligations. Moreover, these assets may affect a child's eligibility for need-based financial aid when applying to college.

GLOBAL *Tax Issues*



Capital Gain Treatment in the United States and Other Countries

Few other countries apply an alternative tax rate or other incentive to long-term capital gains. Instead, those gains are taxed in the same manner as other income. Consequently, even though the U.S. system of identifying and taxing capital assets is complex, it may be preferable because of the lower tax rates, and because the lower rates are available to taxpayers in all tax brackets.

In point of fact, relatively few capital gains are realized by persons in the 10 or 15 percent tax bracket. Thus, the tax rate that generally applies to long-term capital gains is 15 percent.

There are two major exceptions, however, to this general treatment. The first exception relates to so-called *28% property*, which consists of the following items.

- **Collectibles** (works of art, rugs, antiques, gems, coins, stamps, and alcoholic beverages) held more than one year.[19]
- The taxable portion of the gain on sales of *qualified small business stock* (see the end of this section).

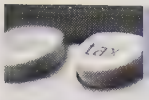
These assets are labeled *28% property*, because the gains that they produce are taxed at 28 percent. But this 28 percent rate is a *maximum* rate, so a taxpayer in a lower tax bracket would pay at that rate. As a result, the benefit of the applicable tax rates for gains on 28% property is as follows.

Ordinary Income Tax Rates	Applicable Tax Rates	Differential (Percentage Points)
10%	10%	None
15	15	None
25	25	None
28	28	None
33	28	5
35	28	7

Note that gains on 28% property receive preferential tax treatment only when realized by taxpayers in the top two tax brackets.

The second major exception involves depreciable real estate that has been held more than one year. Some—but not all—of the gain attributable to depreciation deductions on apartments, office buildings, shopping centers, and warehouses is taxable at 25 percent rather than 0 or 15 percent. The amount that is taxed in this manner depends upon how much depreciation is "recaptured" as ordinary income under § 1250, as explained later in this chapter. Accordingly, these gains are called *unrecaptured § 1250 gain* [§ 1(h)(7)]. In any case, the 25 percent rate is a *maximum* rate, so the benefit of the applicable tax rates for gains from the sale of depreciable real estate is as follows.

[19] § 408(m) and Reg. § 1.408–10(b).



CONCEPT SUMMARY 8.3

Capital Gains of Noncorporate Taxpayers

Type of Asset	Applicable Rate
Held not more than one year.	10%–35%, same as ordinary income.
Collectibles held more than one year.	10/15/25% for lowest bracket taxpayers, 28% for all others.
Taxable portion (50% or 25%) of gain on qualified small business stock held more than five years.	10/15/25% for lowest bracket taxpayers, 28% for all others.
Unrecaptured § 1250 gain on depreciable real estate held more than one year.	10/15% for lowest bracket taxpayers, 25% for all others.
Other capital assets held more than one year.	0% for lowest bracket taxpayers, 15% for all others.

Ordinary Income Tax Rates	Applicable Tax Rates	Differential (Percentage Points)
10%	10%	None
15	15	None
25	25	None
28	25	3
33	25	8
35	25	10

CAPITAL LOSSES

As explained above, capital gains can be classified into four general categories.

- Short term—taxed as ordinary income.
- 28% property—taxed at no more than 28 percent.
- Unrecaptured § 1250 gain—taxed at no more than 25 percent.
- Regular long term—taxed at 0 percent or 15 percent.

A taxpayer can also have losses from capital assets in *three* of these four categories. The *unrecaptured* § 1250 *gain* category contains only gain. When both gains and losses occur in the year, they must be netted against each other in the order specified below.

Step 1. Group all gains and losses into short-term, 28% property, unrecaptured *§ 1250,* and regular long-term categories.

Step 2. Net the gains and losses within each category to obtain net short-term, 28% property, unrecaptured § 1250, and regular long-term gain or loss.

Step 3. Offset the net 28% property and unrecaptured § 1250 amounts if they are of opposite sign. Add them if they have the same sign. Then, offset the resulting amount against the regular net long-term amount if they are of opposite sign, or add the amounts if they have the same sign.

Step 4. Offset the result of step 3 with the net short-term gain *or loss* from step 2 if they are of opposite sign.

These netting rules offset net short-term capital loss against the *highest taxed gain first.* Consequently, if there is a net short-term capital loss, it first offsets any net

28% property gain, any remaining loss offsets unrecaptured § 1250 gain, and then any remaining loss offsets regular long-term gain.

If the result of step 4 is *only* a short-term capital gain, the taxpayer is not eligible for a reduced tax rate. If the result of step 4 is a loss, a **net capital loss** exists, and the taxpayer may be eligible for a *capital loss deduction* (discussed later in this chapter). If there was no offsetting in step 4 because the short-term and step 3 results were both gains *or* if the result of the offsetting is either a 28% property, an unrecaptured § 1250 property, and/or a regular long-term gain, a **net capital gain** exists, and the taxpayer may be eligible for a reduced tax rate. The net capital gain may consist of regular *long-term gain, unrecaptured § 1250 gain,* and/or *28% property gain.* Each of these gains may be taxed at a different rate.

EXAMPLE 29

Joe is in the 35% Federal income tax bracket. He is taxed as follows.

Ordinary income	35%
Unrecaptured § 1250 gain	25%
28% gain	28%
Short-term capital gain	35%
Other long-term capital gain	15%

■

EXAMPLE 30

This example shows how a net long-term capital loss is applied.

Step	Short Term	28% Gain	Unrecaptured § 1250 Gain	Regular Long Term	Comment
1	$ 3,000	$ 1,000		$ 3,000	
				(8,000)	
2	$ 3,000	$ 1,000		($ 5,000)	
3		(1,000)	→	1,000	Netted because of opposite sign.
		$ –0–		($ 4,000)	
4	(3,000)	→	→	3,000	The net short-term gain is netted against the net regular long-term loss, and the remaining loss is eligible for the capital loss deduction.
	$ –0–			($ 1,000)	

■

EXAMPLE 31

This example shows how net short-term and regular long-term capital losses are applied.

Step	Short Term	28% Gain	Unrecaptured § 1250 Gain	Regular Long Term	Comment
1	$ 3,000	$15,000	$4,000	$ 3,000	
	(5,000)	(7,000)		(8,000)	
2	($ 2,000)	$ 8,000	$4,000	($ 5,000)	
3		(5,000)	←	5,000	Net regular long-term loss is netted against 28% gain first.
		$ 3,000		$ –0–	
4	$ 2,000 →	(2,000)			Short-term loss is netted against 28% gain next.
	$ –0–	$ 1,000	$4,000		
		Net 28% gain	Net 25% gain		

■

TAX

Detrimental Tax Treatment for Capital Losses

A corporate taxpayer cannot deduct a net capital loss against ordinary income. It can carry the loss back three years and forward five years in search of capital gains. An individual taxpayer can deduct a maximum of $3,000 of net capital loss against ordinary income in the current tax year. Any excess can be carried forward indefinitely in search of capital gains. After capital gains are exhausted in each carryforward year, a maximum of $3,000 of the remaining net capital loss can be deducted against ordinary income.

The number of individual income tax returns with a net capital loss in AGI is shown below. These numbers increased in the early 2000s, due to drops in stock prices, but they have decreased slightly in the most recent year. Nonetheless, expect them to increase again in the 2008 and 2009 tax years.

Year	Number of Returns (in Millions)
1975	2.5
1980	2.0
1985	2.7
1990	5.0
1995	5.1
2000	6.9
2003	12.8
2006	8.6

Source: Adapted from Justin Bryan, "Individual Income Tax Returns, 2006," *SOI Bulletin*, Fall 2008, Figure C.

If a net loss remains after applying these rules for offsetting losses, a noncorporate taxpayer may deduct up to $3,000 of that loss against ordinary income.[20] Losses in excess of $3,000 are carried over to future years where they are applied first against capital gains and then deducted up to $3,000 per year. Capital loss carryovers expire, however, when the taxpayer dies.

EXAMPLE 32

James incurred a $10,000 loss on his only capital asset transaction in 2010. If he has no other capital asset transactions from that point on, his $10,000 loss is deducted as follows.

Year	Deduction
2010	$3,000
2011	3,000
2012	3,000
2013	1,000

■

EXAMPLE 33

Assume the same facts as in the preceding example, except that James realizes a capital gain of $4,500 in 2012. At that time, his remaining capital loss carryover is $4,000 ($10,000 − $6,000 deducted previously). Since his capital gain in 2012 (i.e., $4,500) exceeds this loss carryforward, James can deduct the entire $4,000 against that year's capital gain. ■

[20] § 1211(b)(1). Married persons filing separate returns are limited to a $1,500 deduction per tax year.

Tax Planning Strategies MATCHING GAINS WITH LOSSES

FRAMEWORK FOCUS: INCOME AND EXCLUSIONS

Strategy: Avoid Income Recognition.

A taxpayer who has already realized a large capital gain may want to *match this gain* with an *offsetting capital loss*. Doing so will shelter the capital gain from taxation and will also free up an asset that has declined in value. Without the capital gain, after all, the taxpayer might hesitate to sell a loss asset, because the resulting capital loss may be deductible only in $3,000 annual increments.

Similarly, a taxpayer with a large realized capital loss might use the occasion to sell some appreciated assets. Doing so would enable the taxpayer to use the capital loss immediately and at the same time realize the benefit of the asset appreciation at little or no tax cost.

On the other hand, matching capital losses and long-term capital gains means that the taxpayer utilizes the capital loss against income that would otherwise qualify for a preferential tax rate of 0 or 15 percent. If the taxpayer's ordinary income is taxed at a higher rate, he or she might prefer to deduct the loss against that higher taxed income, even on a schedule of $3,000 per year. The *time value of money* must be considered; a current-year deduction at 0 or 15 percent might be worth more than a series of annual deductions at higher rates spread over several years.

Nontax considerations, such as investment prospects for the assets in question, are also important. Future investment prospects are often unknowable or at least highly speculative, while tax effects can be determined with relative certainty—which explains some of the late December selling activity in publicly traded securities and mutual funds.

EXAMPLE 33

Assume the same facts as in Example 32, except that James died in late 2011. His remaining capital loss carryforward of $4,000 ($10,000 – $6,000 deducted in 2010 and 2011) expires unused. ■

When a taxpayer's capital loss exceeds $3,000 and derives from more than one category, it is used in the following order: first, short term; then, 28% property; then, unrecaptured § 1250 property; and finally, regular long term. Unused losses are carried forward as follows: short-term losses carry forward as short-term losses, and long-term losses carry forward as long-term losses.

EXAMPLE 34

Nancy incurs a long-term capital loss of $8,500 this year, of which $3,000 is deducted against her ordinary income. The remaining $5,500 ($8,500 loss – $3,000 deducted) carries forward as a long-term capital loss. ■

DIGGING DEEPER 6

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

SMALL BUSINESS STOCK

As originally enacted, a special 50 percent *exclusion* is available to noncorporate taxpayers who derive capital gains from the sale or exchange of **qualified small business stock**.[21] Thus, half of the gain is excluded from the taxpayer's gross income, and the other half is subjected to a maximum tax rate of 28 percent, as noted earlier. However, as part of the American Recovery and Reinvestment Tax Act of 2009, the exclusion temporarily increases to 75 percent for qualified small business stock acquired after February 17, 2009, and before 2011. Thus, the effective tax rate on gains from such stock is 7 percent (28% × 25%).

[21] § 1202(a).

EXAMPLE 36

Yolanda realized a $100,000 gain on the sale of qualified small business stock that she acquired in 2001. Yolanda is subject to the 35% marginal tax rate without considering this gain. So $50,000 of this gain is excluded from her gross income, and the other $50,000 is taxed at a maximum tax rate of 28%. Thus, Yolanda owes tax of $14,000 ($50,000 × 28%), an effective tax rate of 14% on the entire $100,000 capital gain. ■

This treatment is more favorable than the capital gain tax treatment explained previously. Accordingly, Congress imposed additional restrictions to ensure that the gains receiving this treatment were derived in the circumstances that Congress intended to promote. These restrictions include the following.

- The stock must have been newly issued *after* August 10, 1993.
- The taxpayer must have held the stock *more than five years.*
- The issuing corporation must use at least 80 percent of its assets, determined by their value, in the *active conduct* of a trade or business.
- When the stock was issued, the issuing corporation's assets must not have exceeded $50 million, at adjusted basis, including the proceeds of the stock issuance.
- The corporation does not engage in banking, financing, insurance, investing, leasing, farming, mineral extraction, hotel or motel operation, restaurant operation, or any business whose principal asset is the *reputation or skill* of its employees (such as accounting, architecture, health, law, engineering, or financial services).

Even if each of these requirements is met, the amount of gain eligible for the exclusion is limited to the *greater* of 10 times the taxpayer's basis in the stock or $10 million per taxpayer per company,[22] computed on an aggregate basis.

EXAMPLE 37

Vanita purchased $100,000 of qualified small business stock when it was first issued in October 1997. This year, she sells the stock for $4 million. Her gain is $3.9 million ($4,000,000 − $100,000). Although this amount exceeds 10 times her basis ($100,000 × 10 = $1,000,000), it is *less* than $10 million, so the entire $3.9 million gain is eligible for the 50% exclusion. ■

Transactions that fail to satisfy *any one* of the applicable requirements are taxed as capital gains (and losses) realized by noncorporate taxpayers generally.

Gains are also eligible for *nonrecognition* treatment if the sale proceeds are invested in other qualified small business stock within 60 days.[23] To the extent that the sale proceeds are not so invested, gain is recognized, but the exclusion still applies. To be eligible for this treatment, the stock sold must have been held more than six months.

EXAMPLE 38

Assume the same facts as in the preceding example, except that Vanita sold her stock in January 2011 and used $3.5 million of the sale proceeds to purchase other qualified small business stock one month later. Vanita's gain is recognized to the extent that the sale proceeds were not reinvested—namely, $500,000 ($4,000,000 sale proceeds − $3,500,000 reinvested). The 50% exclusion will apply, however, to this amount. ■

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

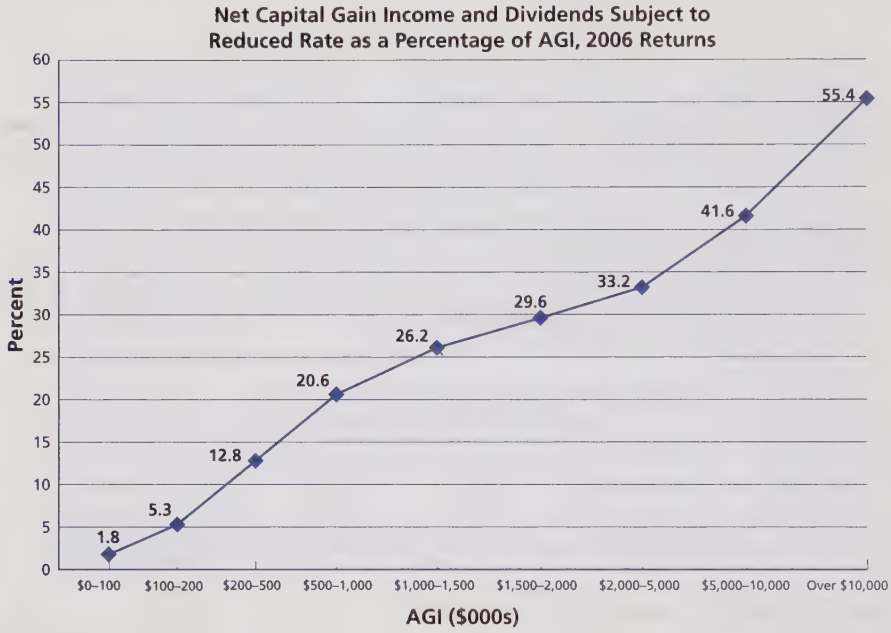


[22]For married persons filing separately, the limitation is $5 million.

[23]§ 1045(a).

Capital Gains for the Wealthy?

Economists and other observers of society often accuse the Code of favoring those with higher levels of income and wealth, despite a fairly substantial progressivity in the Federal income tax rate structure. The claim is that the wealthy are the sole possessors of capital assets, and that capital gains and dividends from those assets are subject to highly favorable tax treatment. Current tax return data may confirm those assertions.



Source: Adapted from Justin Bryan, "Individual Income Tax Returns, 2006," *SOI Bulletin*, Fall 2008, Figure F.

8.6 Tax Treatment of Capital Gains and Losses of Corporate Taxpayers

LO.5

Describe the tax treatment of capital gains and losses for corporate taxpayers.

The treatment of a corporation's net capital gain or loss differs dramatically from the rules for noncorporate taxpayers discussed in the preceding section. Briefly, the differences are as follows.

- Capital gains are taxed at the ordinary income tax rates.[24]
- Capital losses offset only capital gains. No deduction of capital losses is permitted against ordinary taxable income.
- There is a three-year carryback and a five-year carryforward period for net capital losses.[25] Capital loss carrybacks and carryforwards are always treated as short term, regardless of their original nature.

EXAMPLE 14

Sparrow Corporation has a $15,000 long-term capital loss for the current year and $57,000 of ordinary taxable income. Sparrow may not offset the $15,000 long-term capital loss against its ordinary income by taking a capital loss deduction. The $15,000 long-term capital loss becomes a $15,000 short-term capital loss for carryback and carryforward purposes. This amount may offset capital gains in the three-year carryback period

[24] § 1201. The alternative tax rate of 35% produces no beneficial results.

[25] § 1212(a)(1).

or, if not absorbed there, offset capital gains in the five-year carryforward period. Any amount remaining after this carryforward period expires is permanently lost. ■

8.7 Section 1231 Assets

LO.6

Distinguish § 1231 assets from ordinary and capital assets, and calculate § 1231 gain or loss.

Businesses own many assets that are used in the business rather than held for resale. In financial accounting, such assets are known as "fixed assets." For example, a foundry's 30,000-pound stamping machine is a fixed asset. It is also a depreciable asset. The building housing the foundry is another fixed asset. The remainder of this chapter largely deals with how to *classify* the gains and losses from the disposition of fixed assets. Chapter 5 discussed how to depreciate such assets. Chapter 7 discussed how to determine the adjusted basis and the amount of gain or loss from their disposition.

RELATIONSHIP TO CAPITAL ASSETS

At first glance, the *classification of fixed assets* ought to be straightforward. Section 1221(a)(2) specifically excludes from the capital asset definition any property that is depreciable or that is real estate "used in a trade or business." Accordingly, the foundry's stamping machine and the building housing the foundry described earlier are not capital assets. Therefore, one would expect gains to be taxed as ordinary income and losses to be deductible as ordinary losses. Since World War II, however, certain business assets have received more favorable treatment.

Section 1231 provides that business assets held for more than one year can receive the best of both worlds: capital gain treatment on gains and ordinary loss treatment on losses. More specifically, this provision requires that gains and losses from **§ 1231 property** be compiled at the end of the taxable year; the *net result* is then classified as capital gain if a net gain is produced, or as ordinary loss if a net loss is produced. As a result, a particular disposition's character as capital or ordinary is not determined until the taxable year has concluded and all of the taxpayer's **§ 1231 gains and losses** are tabulated.

EXAMPLE 41

Brown & Co. sells business land and building at a $5,000 gain and equipment at a $3,000 loss. Both properties were held for more than one year. Brown's net gain is $2,000, and that net gain may be treated as a long-term capital gain under § 1231. ■

EXAMPLE 42

Chickadee, Inc., sells equipment at a $10,000 loss and business land at a $2,000 gain. Both properties were held for more than one year. Chickadee's net loss is $8,000, and that net loss is an ordinary loss. ■

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.



PROPERTY INCLUDED

Section 1231 property includes the following.

- Depreciable or real property used in business (principally machinery and equipment, buildings, and land).
- Property held for the production of income if it has been involuntarily converted.
- Timber, coal, or domestic iron ore to which § 631 applies.
- Livestock held for draft, breeding, dairy, or sporting purposes.
- Unharvested crops on land used in business.
- Certain *purchased* intangible assets (such as patents and goodwill) that are eligible for amortization.

TAX in the NEWS

Loss from Cattle Rustling

A newspaper in "cattle country" reported that rustlers had stolen 20 head of prime milk cows from a local ranch. The rancher never recovered the cows. According to the article, the rancher had no insurance on the cows and was upset because he had no way of recovering his loss. A CPA might advise the rancher that he could be entitled to a special "theft loss" for tax purposes because the theft loss rules apply to § 1231 assets such as livestock that has been held more than one year.

DIGGING DEEPER 9 10

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

PROPERTY EXCLUDED

Section 1231 property generally does *not* include the following.

- Property not held more than one year. Livestock must be held at least 12 months (24 months in some cases). Unharvested crops do not have to be held more than one year, but the land must be so held.
- Property not put to a personal use, where casualty losses exceed casualty gains for the taxable year. If a taxpayer has a net casualty loss, the casualty gains and losses are treated as ordinary gains and losses.
- Inventory and property held primarily for sale to customers.
- Copyrights; literary, musical, or artistic compositions, etc.; and certain U.S. government publications.
- Accounts receivable and notes receivable arising in the ordinary course of the trade or business.

CASUALTY OR THEFT AND NONPERSONAL-USE CAPITAL ASSETS

When § 1231 assets are disposed of by casualty or theft, a special netting rule is applied. For simplicity, the term *casualty* is used to mean both casualty and theft dispositions. First, the casualty gains and losses from § 1231 assets *and* the casualty gains and losses from **long-term nonpersonal-use capital assets** are determined. For business entities, virtually any capital asset is a nonpersonal-use capital asset, because partnerships, limited liability companies, and corporations are incapable of using assets *personally*. This classification, therefore, is most significant to individual taxpayers who might use certain capital assets as part of their daily life.

Once the casualty gains and losses from § 1231 assets and nonpersonal-use capital assets are determined, they are netted together. If the result is a *net gain*, the net gain is treated as § 1231 gain, but if the result is a *net loss*, the net loss is deducted outside § 1231. Thus, whether these casualties get § 1231 treatment depends on the results of the casualty netting process.

Casualties and thefts are *involuntary conversions*, it should be recalled, and gains from such conversions need not be recognized if the proceeds are timely reinvested in similar property. Thus, the netting process described previously would not consider any casualty and theft gains that are being deferred because insurance proceeds were reinvested according to the requirements of § 1033 (see Chapter 7). Section 1231, in other words, has no effect on whether a *realized* gain or loss is recognized. Instead, § 1231 merely dictates how a *recognized* gain will be classified.

This special netting process for casualties and thefts does not apply to *condemnation* gains and losses. As a result, if a § 1231 asset is disposed of by condemnation, any resulting gain or loss will get § 1231 treatment.

GENERAL PROCEDURE FOR § 1231 COMPUTATION

The tax treatment of § 1231 gains and losses depends on the results of a rather complex *netting* procedure. The steps in this netting procedure are as follows.

Step 1: Casualty Netting

Net all recognized long-term gains and losses from casualties of § 1231 assets and nonpersonal-use capital assets. This casualty netting is beneficial because if there is a net gain, the gain may receive long-term capital gain treatment. If there is a net loss, it receives ordinary loss treatment.

a. If the casualty gains exceed the casualty losses, add the net gain to the other § 1231 gains for the taxable year.
b. If the casualty losses exceed the casualty gains, exclude all casualty losses and gains from further § 1231 computation. The casualty gains are ordinary income and the casualty losses are deductible. For individual taxpayers, the casualty losses must be classified further. For individual taxpayers, § 1231 asset casualty losses are deductible *for* AGI, while other casualty losses are deductible *from* AGI (see Chapter 16).

Step 2: § 1231 Netting

After adding any net casualty gain from step 1a above to the other § 1231 gains and losses (including *recognized* § 1231 asset condemnation gains and losses), net all § 1231 gains and losses.

a. If the gains exceed the losses, the net gain is offset by the "lookback" nonrecaptured § 1231 losses (see step 3 below) from the prior five tax years. To the extent of this offset, the net § 1231 gain is classified as ordinary income. Any remaining gain is long-term capital gain.
b. If the losses exceed the gains, the net loss is deducted against ordinary income. For individual taxpayers only, the gains are ordinary income, the § 1231 asset losses are deductible *for* AGI, and the other casualty losses are deductible *from* AGI.

Falcon Management, Inc., recognized the following gains and losses this year.

Capital Gains and Losses	
Long-term capital gain	$ 3,000
Long-term capital loss	(400)
Short-term capital gain	1,000
Short-term capital loss	(200)

Casualties	
Gain from insurance recovery on fire loss to building, owned five years	$ 1,200
Loss from theft of computer (uninsured), owned two years	(1,000)

§ 1231 Gains and Losses from Depreciable Business Assets Held Long Term	
Asset A	$ 300
Asset B	1,100
Asset C	(500)

Gains and Losses from Sale of Depreciable Business Assets Held Short Term	
Asset D	$ 200
Asset E	(300)

Falcon had no net § 1231 losses in prior tax years.

Disregarding the recapture of depreciation (discussed later in this chapter), Falcon's gains and losses receive the following tax treatment.

- The casualty netting of the § 1231 and nonpersonal-use capital assets contains two items—the $1,200 gain from the business building and the $1,000 loss from the computer. Consequently, there is a $200 net gain and that gain is treated as a § 1231 gain (added to the § 1231 gains).
- The gains from § 1231 transactions (Assets A, B, and C and the § 1231 asset casualty gain) exceed the losses by $1,100 ($1,600 − $500). This excess is a long-term capital gain and is added to Falcon's other long-term capital gains.
- Falcon's net long-term capital gain is $3,700 ($3,000 + $1,100 from § 1231 transactions − $400 long-term capital loss). Its net short-term capital gain is $800 ($1,000 − $200). The result is capital gain income of $4,500, which will be taxed at ordinary rates. If Falcon were an individual rather than a corporation, the $3,700 net long-term capital gain portion would be eligible for preferential capital gain treatment, and the $800 net short-term capital gain would be taxed as ordinary income.
- Falcon treats the gain and loss from Assets D and E as ordinary gain and loss, because § 1231 does not apply unless the assets have been held more than one year.[26]

Results of the Gains and Losses on Falcon's Tax Computation	
Net long-term capital gain	$3,700
Net short-term capital gain	800
Ordinary gain from sale of Asset D	200
Ordinary loss from sale of Asset E	(300)
Gross income	$4,400

■

EXAMPLE 28

Assume the same facts as in the preceding example, except that the loss from Asset C was $1,700 instead of $500.

- The treatment of the casualty gains and losses is the same.
- The losses from § 1231 transactions now exceed the gains by $100 ($1,700 − $1,600). As a result, the net loss is deducted in full as an ordinary loss.
- Capital gain income is $3,400 ($2,600 long term + $800 short term).

Results of the Gains and Losses on Falcon's Tax Computation	
Net long-term capital gain	$2,600
Net short-term capital gain	800
Net ordinary loss on Assets A, B, and C and § 1231 casualty gain	(100)
Ordinary gain from sale of Asset D	200
Ordinary loss from sale of Asset E	(300)
Gross income	$3,200

■

Step 3: § 1231 Lookback Provision

The net § 1231 gain from step 2a above is offset by the nonrecaptured net § 1231 losses for the five preceding taxable years.[27] For 2010, the lookback years are 2005, 2006, 2007, 2008, and 2009. To the extent of the nonrecaptured net § 1231 loss, the current-year net § 1231 gain is ordinary income. The *nonrecaptured* net § 1231 losses are those that have not already been used to offset net § 1231 gains. Only the net § 1231 gain exceeding this net § 1231 loss carryforward is given long-term capital

[26] § 1231(b)(1).

[27] § 1231(c).

gain treatment. The **§ 1231 lookback** provision reduces the taxpayer's ability to gain a tax advantage by "timing" sales artificially.

Komodo Manufacturing Corporation sold various used machines and some business real estate during 2010 for a net § 1231 gain of $25,000. During 2009, Komodo had no § 1231 transactions, but in 2008, it had a net § 1231 loss of $17,000. This loss causes $17,000 of the 2010 gain to be classified as ordinary income. The remaining 2010 gain of $8,000 ($25,000 of § 1231 gain − $17,000 nonrecaptured loss) is § 1231 gain. ■

Assume the same facts as in the preceding example, except that Komodo had a net § 1231 loss of $37,000 in 2008 and a net § 1231 gain of $10,000 in 2009.

- The 2008 net § 1231 loss of $37,000 would cause the net § 1231 gain of $10,000 in 2009 to be classified as ordinary income, and $27,000 ($37,000 loss − $10,000 recaptured) would carry over to 2010.
- The remaining nonrecaptured § 1231 loss of $27,000 from 2008 completely offsets the § 1231 gain of $25,000 from 2010, making that entire gain ordinary income.
- The remaining nonrecaptured § 1231 loss from 2008 is $2,000 ($27,000 carried to 2010 − $25,000 recaptured). This recapture potential carries over to 2011. ■

8.8 Section 1245 Recapture

LO.7

Determine when recapture provisions apply and derive their effects.

As explained earlier, when Congress determined that § 1231 was unduly generous, it chose to *recapture* some of § 1231's benefits rather than repeal that section altogether. This recapture phenomenon applies exclusively to the gain side of § 1231; the ordinary loss feature applicable to § 1231 property is not affected by the Code's recapture provisions. In essence, recapture takes part—often all—of the gain from the sale or exchange of a § 1231 asset and classifies it as *ordinary income* before the netting process of § 1231 begins. Accordingly, recaptured gain is computed *first*, without considering the other § 1231 transactions that occurred during the taxable year. This section discusses the § 1245 recapture rules, and the next section discusses the § 1250 recapture rules.

Section 1245 requires taxpayers to treat all gain as ordinary gain unless the property is sold for more than its original cost. This result is accomplished by requiring that all gain be treated as ordinary gain to the extent of the depreciation taken on the property disposed of. Section 1231 gain results only if the property is disposed of for more than its original cost. The excess of the sales price over the original cost is § 1231 gain. Section 1245 applies primarily to personalty such as machinery, trucks, and office furniture.

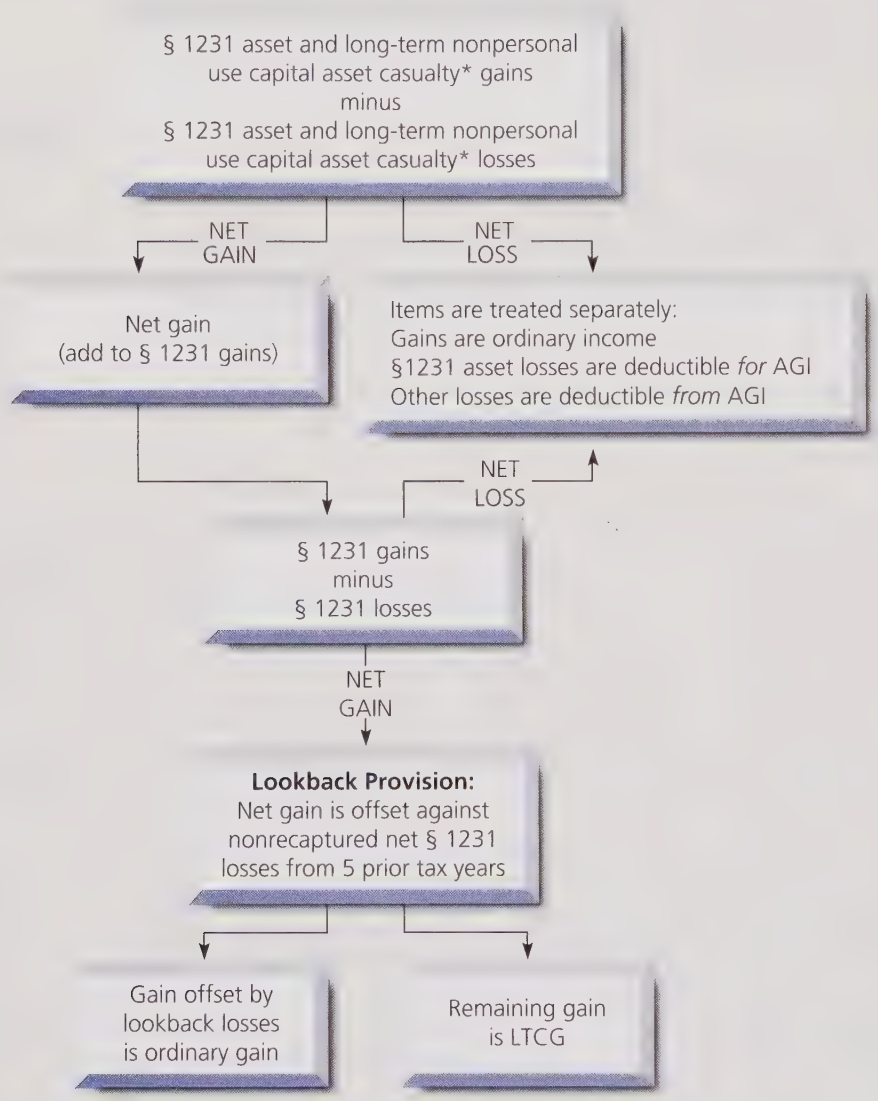
Avocet, Inc., purchased a $100,000 machine and deducted $70,000 of depreciation before selling it for $80,000. Avocet's gain is $50,000 [$80,000 amount realized − $30,000 adjusted basis ($100,000 cost − $70,000 depreciation taken)]. Section 1245 treats as ordinary income (not as § 1231 gain) any gain to the extent of depreciation taken. In this example, the entire $50,000 gain would be ordinary income. ■

If Avocet, Inc., in the preceding example sold the machine for $120,000, it would have a gain of $90,000 ($120,000 amount realized − $30,000 adjusted basis). The § 1245 gain would be $70,000 (equal to the depreciation taken), and the remaining gain of $20,000 (equal to the excess of the sales price over the original cost) would be § 1231 gain. ■

Assume the same facts as in Example 46, except that the asset is sold for $25,000 instead of $80,000. Avocet's loss is $5,000 ($25,000 amount realized − $30,000 adjusted basis). Since there is a loss, there is no depreciation recapture. All of the loss is § 1231 loss. ■

CONCEPT SUMMARY 8.4

Section 1231 Netting Procedure



*Includes casualties and thefts.

Section 1245 recapture applies to the portion of *recognized* gain from the sale or other disposition of § 1245 property that represents depreciation, including § 167 depreciation, § 168 cost recovery, § 179 immediate expensing, § 168(k) additional first-year depreciation, and § 197 amortization. Section 1245 merely *classifies* gain as ordinary income; it does not cause gain to be recognized. Thus, in Example 46, Avocet, Inc., recaptures as ordinary income only the $50,000 of actual gain, not the entire $70,000 of depreciation taken. In other words, § 1245 recaptures the *lower* of the depreciation taken or the gain recognized.

The method of depreciation (e.g., accelerated or straight-line) does not matter. All depreciation taken is potentially subject to recapture. Thus, § 1245 recapture is often referred to as *full recapture*. Any remaining gain after subtracting the amount recaptured as ordinary income will usually be § 1231 gain. The remaining gain is



Bridge to Financial Accounting

The essence of much of the tax code is to create definitions that discriminate among certain types of income or expenditures, so that special tax treatment can be afforded to one of the definitional groups. For instance, municipal bond interest might be favored over corporate bond interest income, long-term capital gains over short-term capital gains or ordinary income, and processing fees to bribes. In each case, the former generally allows a reduction of taxable income or the tax liability and helps the taxpayer meet its goal of maximizing the available after-tax income that it generates.

Maximizing net income also is a goal of financial accounting, at least from the viewpoint of current and potential shareholders. In the long run, stock prices may advance solely because of the positive earnings that the corporation generates relative to the rest of the capital markets. The greater the net earnings, the greater the increase in stock price and private wealth.

But financial accounting makes far fewer distinctions when classifying the reporting entity's revenues and expenses. Most of the tax code's definitions and distinctions are politically or economically motivated means designed to reduce the effective tax rate of the taxpayer, perhaps without affecting its nominal rate.

The preferential treatment of long-term capital gains is one of the most long-lived of these tax fictions. The "best of both worlds" § 1231 treatment is over 65 years old itself. Whereas the gain or loss generated by the sale of a business or investment asset is merely included in the body of the income statement of the reporting entity, § 1221 and § 1231 can reduce the taxpayer's effective tax rate, and § 1245 and § 1250 can increase it.

Differences in classification of income and deductions created solely by the tax code constitute most of the items to be reconciled in the Schedule M–1 or M–3 of the C corporation, S corporation, partnership, and limited liability entity. Many of these items must be reported as permanent or temporary differences in the Deferred Tax Liability account regulated by ASC 740 (SFAS 109).

casualty gain, however, if the asset is disposed of in a casualty event. For example, if the machine in Example 47 had been disposed of by casualty and the $120,000 received had been an insurance recovery, Avocet would still have a gain of $90,000, and $70,000 of that gain would still be recaptured by § 1245 as ordinary gain. The other $20,000 of gain, however, would be casualty gain.

If § 1245 property is disposed of in a transaction other than a sale, exchange, or involuntary conversion, the maximum amount recaptured is the excess of the property's fair market value over its adjusted basis. See the discussion under Exceptions to §§ 1245 and 1250 later in this chapter.

SECTION 1245 PROPERTY

Generally, **§ 1245 property** includes all depreciable personal property (e.g., machinery and equipment), including livestock. Buildings and their structural components usually are not § 1245 property. The following property is *also* subject to § 1245 treatment.

- Amortizable personal property such as goodwill, patents, copyrights, and leaseholds of § 1245 property.
- Professional baseball and football player contracts.
- Expensing of costs to remove architectural and transportation barriers that restrict the handicapped and/or elderly.
- Section 179 immediate expensing of depreciable tangible personal property.
- Certain depreciable tangible real property (other than buildings and their structural components) employed as an integral part of certain activities such as manufacturing and production. For example, a natural gas storage tank where the gas is used in the manufacturing process is § 1245 property.
- Pollution control facilities, railroad grading and tunnel bores, on-the-job training facilities, and child care facilities on which amortization is taken.
- Single-purpose agricultural and horticultural structures and petroleum storage facilities (e.g., a greenhouse or silo).

TAX in the NEWS

Capital Gains Rates, Business Depreciable Equipment, and Depreciable Real Estate

In late 2009, President Obama proposed an increase in the tax rate on long-term capital gains for some "high-income" taxpayers. Only a very careful reading of his proposed tax legislation revealed that this tax increase would not affect most gains from the disposition of business depreciable equipment because such gains are generally taxed as ordinary gains due to depreciation recapture. Thus, these gains are not eligible for long-term capital gain treatment. In contrast, gains from land and depreciable business real estate generally are not subjected to depreciation recapture and, therefore, can receive long-term capital gain treatment. Consequently, such gains could be affected by an increase in capital gains rates.

OBSERVATIONS ON § 1245

- In most instances, the total depreciation taken will exceed the recognized gain. Therefore, the disposition of § 1245 property usually results in ordinary income rather than § 1231 gain. Refer to Example 46.
- Recapture applies to the total amount of depreciation allowed or allowable regardless of the depreciation method used (i.e., full recapture).
- Recapture applies regardless of the holding period of the property. Of course, the entire recognized gain would be ordinary income if the property was not held more than one year, because then § 1231 would not apply.
- Section 1245 does not apply to losses, which receive § 1231 treatment.
- Gains from the disposition of § 1245 assets may also be treated as passive activity gains (refer to Chapter 6).

EXAMPLE 49

Upon sale of some business equipment held for five years, Pink Corporation recognized a $7,500 loss. All of the $20,000 § 1245 depreciation recapture potential for the asset disappears as a result of the disposition. The transaction receives § 1231 loss treatment, and none of Pink's cost recovery deductions are recaptured into ordinary income for this asset. ■

Tax Planning Strategies

Depreciation Recapture and § 179

FRAMEWORK FOCUS: DEDUCTIONS

Strategy: Accelerate Recognition of Deductions to Achieve Tax Deferral.

Section 1245 recapture applies to all types of depreciation, including § 179 *immediate expensing*. Expensing under § 179, however, is elective and entirely within the discretion of the taxpayer. Choosing this option accelerates depreciation on the affected property but increases the potential recapture as well. Therefore, if a taxpayer anticipates that an asset will generate a gain when it is sold and that such sale will occur in the early years of the asset's life, the taxpayer might decide to forgo electing the additional depreciation under § 179.

On the other hand, electing § 179 remains attractive if little or no gain is anticipated upon an asset's disposition. After all, § 1245 recapture applies only to the extent that gain is actually realized. Moreover, even if a substantial gain is anticipated upon an asset's disposition, the *time value of money* might suggest that § 179 be elected if the disposition is expected to be many years away. In any case, the taxpayer can usually control when an asset is sold or exchanged and can thereby extend the time before the taxes saved by electing § 179 must be returned as § 1245 recapture.

8.9 Section 1250 Recapture

Some depreciable property that is not subject to § 1245 recapture faces a separate recapture computation mechanism in § 1250. For the most part, § 1250 applies to *depreciable real property* (principally buildings and their structural components), such as apartments, office buildings, factories, stores, and warehouses. Intangible real property, such as leaseholds of **§ 1250 property**, also is included.

Section 1250 recapture is much less onerous than § 1245 recapture, but it is also much more complex. Section 1250 recaptures only a property's **additional depreciation**, which is the excess of the depreciation actually deducted over the amount that would have been allowed under the straight-line method of depreciation. For this reason, § 1250 recapture is often referred to as *partial recapture*, in contrast to § 1245's full recapture.

Since § 1250 recaptures only the excess over straight-line depreciation, the concept does not apply to properties that were depreciated using the straight-line method (unless they were held for one year or less). Real property placed in service *after 1986* can only be depreciated using the straight-line method, so there is *no § 1250 recapture* upon the disposition of such properties that are held for longer than one year.

But real estate is particularly long-lived, and many dispositions of such assets involve properties placed in service *before 1987*, when accelerated depreciation was often available for real estate. Finally, § 1250 does not affect the § 1231 treatment of realized losses.

When straight-line depreciation is used, there is no § 1250 recapture potential unless the property is disposed of in the first year of use. For real property placed in service after 1986, only straight-line depreciation is generally allowed. Therefore, the application of § 1250 is limited to first-year dispositions.

Sanjay Enterprises, Ltd., acquires a residential rental building on January 1, 2009, for $300,000. It receives an offer of $450,000 for the building and sells it on December 23, 2010.

- Sanjay takes $20,909 [($300,000 × .03485) + ($300,000 × .03636 × $^{11.5}/_{12}$) = $20,909] of total depreciation for 2009 and 2010. The adjusted basis of the property is $279,091 ($300,000 − $20,909).
- Sanjay's recognized gain is $170,909 ($450,000 − $279,091).
- All of the gain is § 1231 gain. ■

Concept Summary 8.5 compares and contrasts the § 1245 and § 1250 depreciation recapture rules.

UNRECAPTURED § 1250 GAIN (REAL ESTATE 25% GAIN)

As noted previously, *noncorporate taxpayers* pay tax at a maximum rate of 25 percent on their **unrecaptured § 1250 gain**. This gain represents that part of the gain on § 1250 property that is attributable to depreciation that was not recaptured by § 1250.

The procedure for computing this amount involves three distinct steps.

Step 1. Determine the part of the recognized gain that is attributable to *depreciation deductions* claimed in prior years.

Step 2. Apply § 1250 to determine the portion of the gain calculated in step 1 that is recaptured as ordinary income.

Step 3. Subtract the gain recaptured under § 1250 (step 2) from the gain derived in step 1. This amount is the *unrecaptured § 1250 gain.*

CONCEPT SUMMARY 8.5

Comparison of § 1245 and § 1250 Depreciation Recapture

	§ 1245	§ 1250
Property affected	All depreciable personal property, including items such as § 179 expense and § 197 amortization of intangibles such as goodwill, patents, and copyrights.	Nonresidential real property acquired after 1969 and before 1981, on which accelerated depreciation was taken. Residential rental real property acquired after 1975 and before 1987, on which accelerated depreciation was taken. Additional first-year depreciation [§168(k)] exceeding straight-line depreciation taken on leasehold improvements to nonresidential property.
Depreciation recaptured	Potentially all depreciation taken. If the selling price is greater than or equal to the original cost, all depreciation is recaptured. If the selling price is between the adjusted basis and the original cost, only some depreciation is recaptured.	Additional depreciation (the excess of accelerated depreciation over straight-line depreciation). All depreciation taken if property disposed of in first year.
Limit on recapture	Lower of depreciation taken or gain recognized.	Lower of additional depreciation or gain recognized.
Treatment of gain exceeding recapture gain	Usually § 1231 gain.	Usually § 1231 gain.
Treatment of loss	No depreciation recapture; loss is usually § 1231 loss.	No depreciation recapture; loss is usually § 1231 loss.

EXAMPLE 11

Linda placed two apartment buildings in service at a cost of $100,000 each. On each building, she claimed accelerated depreciation deductions of $78,000, and straight-line depreciation would have been $64,000. Thus, her adjusted basis for each building is $22,000 ($100,000 cost − $78,000 depreciation deducted), and her potential § 1250 recapture on each building is $14,000 ($78,000 accelerated depreciation − $64,000 straight-line). She now sells these buildings for $96,000 and $110,000, respectively, and computes her gain as follows.

	Building A	Building B
Amount realized	$ 96,000	$110,000
Adjusted basis	(22,000)	(22,000)
Recognized gain	$ 74,000	$ 88,000
Depreciation recaptured by § 1250	(14,000)	(14,000)
Remaining gain	$ 60,000	$ 74,000
Unrecaptured § 1250 gain	(60,000)	(64,000)
§ 1231 gain	None	$ 10,000

■

For property placed in service after 1986, § 1250 generally does not apply, because such property may use only straight-line depreciation under MACRS. As a result, *all* of the gain attributable to depreciation on such assets is unrecaptured § 1250 gain.

ADDITIONAL RECAPTURE FOR CORPORATIONS

Although depreciation recapture is generally the same for all taxpayers, corporations that sell depreciable real estate face an additional amount of depreciation recapture. Section 291(a)(1) requires recapture of 20 percent of the excess of the amount that would be recaptured under § 1245 over the amount actually recaptured under § 1250.

EXAMPLE 52

Franklin Corporation purchased an apartment building for $300,000. Accelerated depreciation was taken in the amount of $260,000 before the building was sold for $250,000. Straight-line depreciation would have been $245,000. The corporation's depreciation recapture and § 1231 gain are computed as follows.

Sales price	$250,000
Less: Adjusted basis [$300,000 (cost of building) − $260,000 (MACRS depreciation)]	(40,000)
Recognized gain	$210,000
Ordinary income if property were § 1245 property	$210,000
Less: Gain recaptured under § 1250 ($260,000 − $245,000)	(15,000)
Excess § 1245 gain	$195,000
Apply § 291 percentage	× 20%
Additional § 291 gain recaptured	$ 39,000
Ordinary income from depreciation recapture ($15,000 + $39,000)	$ 54,000
Section 1231 gain ($210,000 − $54,000)	156,000
Total recognized gain	$210,000

■

EXAMPLE 53

If the building in the preceding example were commercial property and straight-line depreciation was used, no § 1250 recapture results. A corporate taxpayer still must recapture as ordinary income 20% of the depreciation that would be ordinary income if the property were § 1245 property.

Sales price	$250,000
Less: Adjusted basis [$300,000 (cost of building) − $245,000 (straight-line depreciation)]	(55,000)
Recognized gain	$195,000
Ordinary income if property were § 1245 property	$195,000
Less: Ordinary income under § 1250	(–0–)
Excess ordinary income under § 1245	$195,000
Apply § 291 percentage	× 20%
Ordinary income under § 291	$ 39,000

Thus, $39,000 of the $195,000 gain would be ordinary income, and $156,000 would be § 1231 gain. ■

8.10 EXCEPTIONS TO §§ 1245 AND 1250

Recapture under §§ 1245 and 1250 does not apply to the following transactions.

GIFTS

Depreciation recapture potential carries over to the donee.[28]

[28] §§ 1245(b)(1) and 1250(d)(1) and Reg. §§ 1.1245–4(a)(1) and 1.1250–3(a)(1).

Tax Planning Strategies SELLING DEPRECIABLE REAL ESTATE

FRAMEWORK FOCUS: DEDUCTIONS

Strategy: Maximize Deductible Amounts.

FRAMEWORK FOCUS: TAX RATE

Strategy: Control the Character of Income and Deductions.

A building depreciated on an accelerated method eventually generates annual allowances that are smaller than the amount that the straight-line method would have produced. Beyond that "cross-over" point, the *cumulative* amount of "additional depreciation" is reduced every year the asset is operated. Doing so effectively converts gain that would otherwise be subject to § 1250 recapture into "unrecaptured § 1250 gain," enabling the taxpayer to save the difference between the applicable tax rate on ordinary income and 25 percent.

Continuing to operate the building, however, brings forth an array of important *nontax considerations*. Each year a building is used subjects it to additional maintenance expenses to keep it in operating condition. Moreover, a building's appeal to current and prospective tenants tends to decline over time as newer structures appear offering more modern amenities, such as wireless high-speed Internet access, and other conveniences. Finally, local real estate developments might produce lower resale prices that offset much, if not all, of the tax advantage obtained by holding the property for the additional time.

EXAMPLE 15

Wade gives his daughter, Helen, § 1245 property with an adjusted basis of $1,000. The amount of recapture potential is $700. Helen uses the property in her business and claims further depreciation of $100 before selling it for $1,900. Helen's recognized gain is $1,000 [$1,900 amount realized − $900 adjusted basis ($1,000 carryover basis − $100 depreciation taken by Helen)], of which $800 is recaptured as ordinary income ($100 depreciation taken by Helen + $700 recapture potential carried over from Wade). The remaining gain of $200 is § 1231 gain. Even if Helen had used the property for personal purposes, the $700 recapture potential would have carried over. ■

DEATH

Although not an attractive tax planning approach, death eliminates all recapture potential.[29] Depreciation recapture potential does not carry over from a decedent to an estate or an heir.

EXAMPLE 16

Assume the same facts as in the preceding example, except that Helen receives the property as a result of Wade's death. The $700 recapture potential from Wade is extinguished at his death. Helen has a basis in the property equal to its fair market value (assume $1,700) at Wade's death. She will have a $300 gain when the property is sold because the selling price ($1,900) exceeds the property's adjusted basis of $1,600 ($1,700 basis to Helen − $100 depreciation) by $300. Because of § 1245, Helen has ordinary income of $100. The remaining gain of $200 is § 1231 gain. ■

CHARITABLE TRANSFERS

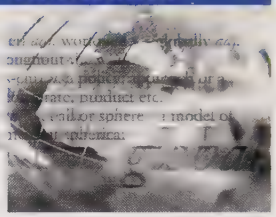
Depreciation recapture potential reduces the amount of any charitable contribution deduction.[30]

[29] §§ 1245(b)(2) and 1250(d)(2).

[30] § 170(e)(1)(A) and Reg. § 1.170A–4(b)(1). In certain circumstances, § 1231 gain also reduces the amount of the charitable contribution. See § 170(e)(1)(B).

EXCHANGE FOR FOREIGN PROPERTY YIELDS RECOGNIZED RECAPTURE GAIN

GLOBAL *Tax Issues*



Tangible personal property used in a trade or business may be the subject of a like-kind exchange, and the postponed gain is most likely postponed § 1245 gain. However, tangible personal property used predominantly within the United States cannot be exchanged for tangible personal property used predominantly outside the United States. Thus, such an exchange would cause recognized gain, and, as long as the fair market value of the property given up does not exceed its original cost, all of the gain is § 1245 depreciation recapture gain.

EXAMPLE 10

Bullfinch Corporation donates to a museum § 1245 property with a fair market value of $10,000 and an adjusted basis of $7,000. Depreciation recapture potential is $2,000 (the amount of recapture that would occur if the property were sold). The company's charitable contribution deduction (subject to the limitations discussed in Chapter 5) is $8,000 ($10,000 fair market value − $2,000 recapture potential). ■

CERTAIN NONTAXABLE TRANSACTIONS

In certain transactions, the transferor's adjusted basis for the property carries over to the transferee. Then, depreciation recapture potential also carries over to the transferee.[31] Included in this category are transfers of property pursuant to the following.

- Nontaxable incorporations under § 351.
- Certain liquidations of subsidiary corporations under § 332.
- Nontaxable contributions to a partnership under § 721.
- Nontaxable corporate reorganizations.

Gain may be recognized in these transactions if boot is received. If gain is recognized, it is treated as ordinary income to the extent of the recapture potential or the recognized gain, whichever is lower.[32]

LIKE-KIND EXCHANGES AND INVOLUNTARY CONVERSIONS

As explained in Chapter 7, realized gain is recognized to the extent of boot received in a like-kind exchange. Realized gain is also recognized to the extent the proceeds from an involuntary conversion are not reinvested in similar property. Such recognized gain is subject to recapture as ordinary income under §§ 1245 and 1250. Any remaining recapture potential carries over to the property received in the exchange.

EXAMPLE 11

Crane Corporation exchanges § 1245 property with an adjusted basis of $300 for § 1245 property with a fair market value of $6,000 plus $1,000 cash (boot). The exchange qualifies as a like-kind exchange under § 1031. Crane's realized gain is $6,700 ($7,000 amount realized − $300 adjusted basis of property).

Since Crane received boot of $1,000, it recognizes gain to this extent. Assuming the recapture potential is $7,500, Crane recognizes § 1245 gain of $1,000. The remaining recapture potential of $6,500 carries over to the like-kind property received. ■

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.



[31] §§ 1245(b)(3) and 1250(d)(3). Reg. §§ 1.1245–2(a)(4) and (c)(2), 1.1245–4(c), 1.1250–2(d)(1) and (3).

[32] §§ 1245(b)(3) and 1250(d)(3), and Reg. §§ 1.1245–4(c) and 1.1250–3(c).

8.11 Reporting Procedures

Noncapital gains and losses are reported on Form 4797, Sales of Business Property. Before filling out Form 4797, however, Form 4684, Casualties and Thefts, Part B, must be completed to determine whether any casualties will enter into the § 1231 computation procedure. Recall that recognized gains from § 1231 asset casualties may be recaptured by § 1245 or § 1250. These gains do not appear on Form 4684. The § 1231 gains and nonpersonal-use long-term capital gains are netted against § 1231 and nonpersonal-use long-term capital losses on Form 4684 to determine if there is a net gain to transfer to Form 4797, Part I.



In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

Tax Planning Strategies Timing of Recapture

FRAMEWORK FOCUS: TAX RATE

Strategy: Shift Net Income from High-Bracket Years to Low-Bracket Years.
Shift Net Income from High-Bracket Taxpayers to Low-Bracket Taxpayers.

Since recapture is usually not triggered until the property is sold or disposed of, it may be possible to plan for recapture in low-bracket or loss years. If a taxpayer has net operating loss carryovers that are about to expire, the recognition of ordinary income from recapture may be advisable to absorb the loss carryovers.

EXAMPLE 58

Angel Corporation has a $15,000 net operating loss carryover that will expire this year. It owns a machine that it plans to sell in the early part of next year. The expected gain of $17,000 from the sale of the machine will be recaptured as ordinary income under § 1245. Angel sells the machine before the end of this year and offsets $15,000 of the ordinary income against the net operating loss carryover. ■

It is also possible to postpone recapture or to shift the burden of recapture to others. For example, recapture is avoided upon the disposition of a § 1231 asset if the taxpayer replaces the property by entering into a like-kind exchange. In this instance, recapture potential is merely carried over to the newly acquired property (refer to Example 57).

Recapture can be shifted to others through the gratuitous transfer of § 1245 or § 1250 property to family members. A subsequent sale of such property by the donee will trigger recapture to the donee rather than the donor (refer to Example 54). This technique is advisable when the donee is in a lower income tax bracket than the donor.

8.12 Summary

The lower tax rates afforded long-term capital gains present numerous definitional and computational challenges. Most of these rules are found in court decisions and Regulations rather than in the Code. The tax professional needs to use good software to analyze all of the possibilities that are available.

REFOCUS ON THE BIG PICTURE

The land, stock, and home owned by Alice are all capital assets and will produce capital gain or loss when sold. Accordingly, Alice will have a long-term capital gain of $48,000 from the sale of the land, a long-term capital gain of $6,000 from the sale of 300 shares of inherited stock, a short-term capital loss of $4,000 from the sale of the other 200 shares of stock, and a $125,000 long-term capital gain from the sale of the house.

The depreciable property owned by Alice's husband is § 1231 property. The $45,000 gain from the sale of the property ($60,000 amount realized − $15,000 basis) is subject to depreciation recapture under § 1245. Accordingly, the first $35,000 of the gain (up to the amount of depreciation taken on the property) is taxed as ordinary income. The remaining $10,000 is given long-term capital gain treatment.

As a result of these transactions, Alice and her husband have a net long-term capital gain of $189,000 ($48,000 + $6,000 + $125,000 + $10,000) and a net short-term capital loss of $4,000. The long-term capital gain and short-term capital loss are netted, so the final result is a net capital gain of $185,000, which is taxed at a 15 percent tax rate. Alice and her husband also report $35,000 of ordinary income on their joint income tax return.

What If?

What if the depreciable business property was worth only $10,000 when it was sold? In this case, there is no depreciation recapture, and the $5,000 loss is deductible as an ordinary loss.

CAPITAL GAINS AND LOSSES, § 1231 GAINS AND LOSSES, AND RECAPTURE

SUGGESTED READINGS

Michael Allen, "Gain Tax Benefits by Allocating Price before Closing Sale of Business," *Practical Tax Strategies*, November 2008.

Agatha E. Jeffers and Leonard J. Lauricella, "Tax Implications of Investment Losses from the Madoff Ponzi Scheme," *Practical Tax Strategies*, May 2009.

William S. McKee, William F. Nelson, Robert L. Whitmire, Gary R. Huffman, and James P. Whitmire, "Special Tax Problems May Surface on the Death of a Partner," *Practical Tax Strategies*, May 2007.

"Shop Talk: The Indestructible Bartman Ball: Back in the (Tax) Limelight," *Journal of Taxation*, October 2007.

KEY TERMS

Additional depreciation, 8–33
Capital assets, 8–3
Capital gain, 8–3
Capital losses, 8–3
Collectibles, 8–18
Franchise, 8–11
Holding period, 8–13
Lessee, 8–12
Lessor, 8–12
Long-term nonpersonal-use capital assets, 8–26
Net capital gain, 8–20
Net capital loss, 8–20
Options, 8–8
Patent, 8–10
Qualified small business stock, 8–22
Sale or exchange, 8–7
Section 1231 gains and losses, 8–25
Section 1231 lookback, 8–29
Section 1231 property, 8–25
Section 1245 property, 8–31
Section 1245 recapture, 8–30
Section 1250 property, 8–33
Section 1250 recapture, 8–33
Short sale, 8–15
Unrecaptured § 1250 gain, 8–33

PROBLEMS

1. **LO.1** Mariah had three property transactions during the year. She sold a vacation home used only for personal purposes at a $35,000 loss. The home had been held for five years and had never been rented. Mariah also sold an antique clock for $13,500 that she had inherited from her grandmother. The clock was valued in Mariah's grandmother's estate at $12,000. Mariah owned the clock for only four months. She sold these assets to finance her full-time occupation as a song writer. Near the end of the year, Mariah sold one of the songs she had written two years earlier. She received cash of $50,000 and a royalty interest in revenues derived from the merchandising of the song. Mariah had no tax basis for the song. What is Mariah's gross income?

ISSUE ID

2. **LO.1** An individual taxpayer sells some used assets at a garage sale. Why are none of the proceeds taxable in most situations?

3. **LO.1** During the year, Eric had the four property transactions summarized below. Eric is a collector of antique automobiles and occasionally sells one to get funds to buy another. What are the amount and nature of the gain or loss from each of these transactions?

Property	Date Acquired	Date Sold	Adjusted Basis	Sales Price
Antique truck	06/18/99	05/23/10	$47,000	$42,000
Blue Growth Fund (100 shares)	12/23/01	11/22/10	12,000	28,000
Orange bonds	02/12/02	04/11/10	34,000	42,000*
Green stock (100 shares)	02/14/10	11/23/10	13,000	11,000

*The sales price included $750 of accrued interest income.

DECISION MAKING

4. **LO.1** Revez owns an antique shop. He buys property from estates, often at much less than the retail value of the property. Recently, Revez sold for $4,000 an antique clock for which he had paid $1,250. Revez had held the clock in his shop for 36 months before selling it. Revez would like the gain on the sale of the clock to be a long-term capital gain. How can he achieve that objective?

5. **LO.1** Gladwin is the owner of numerous office buildings. His intention is to hold the buildings until they increase in value and then sell them. He rents the buildings to tenants while he is holding them. In 2010, he sold a building for $4.5 million. He had held the building for 15 years, and it had a tax basis of $2 million. Was the building a capital asset? Why or why not.

COMMUNICATIONS

6. **LO.1** Hyacinth, Inc., is a dealer in securities. The firm has spotted a fast-rising company and would like to buy and hold its stock for investment. The stock is currently selling for $15 per share, and Hyacinth thinks it will climb to $63 a share within two years. How can Hyacinth ensure that any gain it realizes will be taxed as long-term capital gain? Draft a letter responding to Hyacinth's inquiry. The firm's address is 200 Morningside Drive, Hattisburg, MS 39406.

7. **LO.1** Eagle Partners meets all the requirements of § 1237 (subdivided realty). In 2010, Eagle Partners begins selling lots and sells four separate lots to four different purchasers. Eagle Partners also sells two contiguous lots to another purchaser. The sale price of each lot is $20,000. The partnership's basis for each lot is $15,000. Selling expenses are $500 per lot.
   a. What are the realized and recognized gain?
   b. Explain the nature of the gain (i.e., ordinary income or capital gain).
   c. Would your answers change if, instead, the lots sold to the fifth purchaser were not contiguous? If so, how?

CRITICAL THINKING

8. **LO.1, 2** Albert purchased $400,000 of Brown Corporation face value bonds for $320,000 on November 13, 2009. The bonds had been issued with $80,000 of original issue discount because Brown was in financial difficulty in 2009. On December 3, 2010, Albert

sold the bonds for $383,000 after amortizing $1,000 of the original issue discount. What are the nature and amount of Albert's gain or loss?

9. **LO.2** Celia was the owner of vacant land that she was holding for investment. She paid $1 million for the land in 2005. Ichiro was an investor in vacant land. He thought Celia's land might be the site of an exit ramp from a new freeway. Ichiro gave Celia $420,000 for an option on her land in 2008. The option was good for two years and gave Ichiro the ability to purchase Celia's land for $4,765,000. The freeway was not approved by the government, and Ichiro's option expired in 2010. Does Celia have $420,000 of long-term capital gain upon the expiration of the option?

10. **LO.2, 3, 4** Mateen, an inventor, obtained a patent on a chemical process to clean old aluminum siding so that it can be easily repainted. Mateen has a zero tax basis in the patent. Mateen does not have the capital to begin manufacturing and selling this product, so he has done nothing with the patent since obtaining it two years ago. **DECISION MAKING**

    Now a group of individuals has approached him and offered two alternatives. Under one alternative, they will pay Mateen $400,000 (payable evenly over the next 10 years) for the exclusive right to manufacture and sell the product. Under the other, they will form a business and contribute capital to it to begin manufacturing and selling the product; Mateen will receive 20% of the company's shares of stock in exchange for all of his patent rights. Discuss which alternative is better for Mateen.

11. **LO.2** Green Corporation and Red Corporation are engaged in a contract dispute over the use of Green's trademarked name, Big Blue Taco. For a one-time payment of $45,000, Green licensed Red to use the name Big Blue Taco, but the license did not require that Red use the same materials in its version of Big Blue Taco that Green uses. Red also did not have to make any contingent payments to Green or buy any supplies from Green. Did Red purchase a franchise right from Green, or did Red purchase the name Big Blue Taco from Green?

12. **LO.2** Freys, Inc., sells a 12-year franchise to Red Company. The franchise contains many restrictions on how Red may operate its store. For instance, Red cannot use less than Grade 10 Idaho potatoes, must fry the potatoes at a constant 410 degrees, dress store personnel in Freys-approved uniforms, and have a Freys sign that meets detailed specifications on size, color, and construction. When the franchise contract is signed, Red makes a noncontingent $160,000 payment to Freys. During the same year, Red pays Freys $300,000—14% of Red's sales. How does Freys treat each of these payments? How does Red treat each of the payments?

13. **LO.3** Cherie held vacant land that qualified as an investment asset. She purchased the vacant land on April 10, 2006. She exchanged the vacant land for an apartment building in a qualifying like-kind exchange on January 22, 2010. Cherie was going to hold the apartment building for several years and then sell it. However, she got an "offer she could not refuse" and sold it on November 22, 2010, for a substantial gain. What was Cherie's holding period for the apartment building?

14. **LO.4** Thrasher Corporation sells short 100 shares of ARC stock at $20 per share on January 15, 2010. It buys 200 shares of ARC stock on April 1, 2010, at $25 per share. On May 2, 2010, Thrasher closes the short sale by delivering 100 of the shares purchased on April 1. **CRITICAL THINKING**
    a. What are the amount and nature of Thrasher's loss upon closing the short sale?
    b. When does the holding period for the remaining 100 shares begin?
    c. If Thrasher sells (at $27 per share) the remaining 100 shares on January 20, 2011, what will be the nature of its gain or loss?

15. **LO.1, 3, 4** Elaine Case (single with no dependents) has the following transactions in 2010: **COMMUNICATIONS**

AGI (exclusive of capital gains and losses)	$240,000
Long-term capital gain	22,000
Long-term capital loss	(8,000)
Short-term capital gain	19,000
Short-term capital loss	(23,000)

What is Elaine's net capital gain or loss? Draft a letter to Elaine describing how the net capital gain or loss will be treated on her tax return. Assume Elaine's income from other sources puts her in the 35% bracket. Elaine's address is 300 Ireland Avenue, Shepherdstown, WV 25443.

DECISION MAKING

16. **LO.4** Sally has taxable income of $160,000 as of November 30 of this year. She wants to sell a Rodin sculpture that has appreciated $90,000 since she purchased it six years ago, but she does not want to pay more than $15,000 of additional tax on the transaction. Sally also owns various stocks, some of which are currently worth less than their basis. How can she achieve her desired result?

17. **LO.5** Platinum, Inc., has determined its taxable income as $215,000 before considering the results of its capital gain or loss transactions. Platinum has a short-term capital loss of $24,000, a long-term capital loss of $38,000, and a short-term capital gain of $39,000. What is Platinum's taxable income, and what (if any) are the amount and nature of its capital loss carryover?

ETHICS AND EQUITY

18. **LO.1, 4** The taxpayer is an antiques collector and is going to sell an antique purchased many years ago for a large gain. The facts and circumstances indicate that the taxpayer might be classified as a dealer rather than an investor in antiques. The taxpayer will save $40,000 in taxes if the gain is treated as long-term capital gain rather than as ordinary income. The taxpayer is considering the following options as ways to assure the $40,000 tax savings.

- Give the antique to his daughter, who is an investment banker, to sell.
- Merely assume that he has held the antique as an investment.
- Exchange the antique in a like-kind exchange for another antique he wants.

One of the tax preparers the taxpayer has contacted has said he would be willing to prepare the return under the second option. Would you? Why? Evaluate the other options.

COMMUNICATIONS

19. **LO.1, 4** In 2010, Betty (head of household with three dependents) had an $18,000 loss from the sale of a personal residence. She also purchased from an individual inventor for $18,000 (and resold in two months for $7,000) a patent on a rubber bonding process. The patent had not yet been reduced to practice. Betty purchased the patent as an investment. Additionally, she had the following capital gains and losses from stock transactions:

Long-term capital loss	($ 5,000)
Long-term capital loss carryover from 2009	(12,000)
Short-term capital gain	21,000
Short-term capital loss	(6,000)

What is Betty's net capital gain or loss? Draft a letter to Betty explaining the tax treatment of the sale of her personal residence. Assume Betty's income from other sources puts her in the 35% bracket. Betty's address is 1120 West Street, Ashland, OR 97520.

ISSUE ID

20. **LO.1, 3, 4** Bridgette is known as the "doll lady." She started collecting dolls as a child, always received one or more dolls as gifts on her birthday, never sold any dolls, and eventually owned 600 dolls. She is retiring and moving to a small apartment and has decided to sell her collection. She lists the dolls on an Internet auction site and, to her great surprise, receives an offer from another doll collector of $45,000 for the entire collection. Bridgette sells the entire collection, except for five dolls that she purchased during the last year. She had owned all the dolls sold for more than a year. What tax factors should Bridgette consider in deciding how to report the sale?

CRITICAL THINKING

21. **LO.1** Two years ago, Hsui Company (an unincorporated entity) developed a process for preserving fresh fruit that gives the fruit a much longer shelf life. The process is not patented or copyrighted, and only Hsui knows how it works. A conglomerate has approached Hsui with an offer to purchase the formula for the process. Specifically, the offer allows Hsui to choose between the following. Which option should Hsui accept?

- $850,000 cash for the formula and a 10-year covenant not to compete, paying Hsui $45,000 per year for 10 years.
- $850,000 cash for a 10-year covenant not to compete, and an annual $45,000 royalty for the formula, payable for 10 years.

22. **LO.6** A painting that Tulip & Co. held for investment was destroyed in a flood. The painting was insured, and Tulip had a $60,000 gain from this casualty. It also had a $27,000 loss from an uninsured antique vase that was destroyed by the flood. The vase was also held for investment. Tulip had no other property transactions during the year and has no nonrecaptured § 1231 losses from prior years. Compute Tulip's net gain or loss and identify how it would be treated. Write a letter to Tulip explaining the nature of the gain or loss. Tulip's address is 2367 Meridian Road, Hannibal Point, MO 34901. **COMMUNICATIONS**

23. **LO.6, 7** Sylvia owns two items of business equipment. They were both purchased in 2006 for $100,000, both have a seven-year recovery period, and both have an adjusted basis of $37,490. Sylvia is considering selling these assets in 2010. One of them is worth $40,000, and the other is worth $23,000. Since both items were used in her business, Sylvia simply assumes that the loss on one will be offset against the gain from the other and the net gain or loss will increase or reduce her business income. Is she correct? **ISSUE ID**

24. **LO.6** Harold, a CPA, has a new client who recently moved to town. Harold prepares the client's current-year tax return, which shows a net § 1231 gain. Harold calls the client to request copies of the returns for the preceding five years to determine if there are any § 1231 lookback losses. The client says that the returns are "still buried in the moving mess somewhere" and cannot be found. The client also says that he does not remember any § 1231 net losses on the prior-year returns. What should Harold do? Justify your answer. **ETHICS AND EQUITY**

25. **LO.6** Geranium, Inc., has the following net § 1231 results for each of the years shown. What is the nature of the net gain in 2009 and 2010?

Tax Year	Net § 1231 Loss	Net § 1231 Gain
2005	$18,000	
2006	33,000	
2007	32,000	
2008		$42,000
2009		30,000
2010		41,000

26. **LO.6** Delphinium Company owns two parcels of land (§ 1231 assets). One parcel can be sold at a loss of $50,000, and the other parcel can be sold at a gain of $70,000. The company has no nonrecaptured § 1231 losses from prior years. The parcels could be sold at any time because potential purchasers are abundant. The company has a $25,000 short-term capital loss carryover from a prior tax year and no capital assets that could be sold to generate long-term capital gains. What should Delphinium do based upon these facts? **DECISION MAKING**

27. **LO.6, 7** Green Industries (a sole proprietorship) sold three § 1231 assets on October 10, 2010. Data on these property dispositions are as follows.

Asset	Cost	Acquired	Depreciation	Sold for
Rack	$100,000	10/10/06	$70,000	$75,000
Forklift	35,000	10/16/07	23,000	5,000
Bin	87,000	3/12/09	34,000	60,000

a. Determine the amount and the character of the recognized gain or loss from the disposition of each asset in 2010.
b. Assuming Green has no nonrecaptured net § 1231 losses from prior years, how much of the recognized gains are treated as long-term capital gains?

28. **LO.6, 7** On December 1, 2008, Gray Manufacturing Company (a corporation) purchased another company's assets, including a patent. The patent was used in Gray's manufacturing operations; $40,500 was allocated to the patent, and it was amortized at the rate of $225 per month. On June 30, 2010, Gray sold the patent for $70,000. Twenty months of amortization had been taken on the patent. What are the amount and nature of the gain Gray recognizes on the disposition of the patent? Write a letter to Gray discussing the **COMMUNICATIONS**

treatment of the gain. Gray's address is 6734 Grover Street, Back Bay Harbor, ME 23890. The letter should be addressed to Siddim Sadatha, Controller.

29. **LO.6, 7** Dave is the sole proprietor of a trampoline shop. During 2010, the following transactions occurred.

- Unimproved land adjacent to the store was condemned by the city on February 1. The condemnation proceeds were $25,000. The land, acquired in 1984, had an allocable basis of $40,000. Dave has additional parking across the street and plans to use the condemnation proceeds to build his inventory.
- A truck used to deliver trampolines was sold on January 2 for $3,500. The truck was purchased on January 2, 2006, for $6,000. On the date of sale, the adjusted basis was $2,509.
- Dave sold an antique rowing machine at an auction. Net proceeds were $3,900. The rowing machine was purchased as used equipment 17 years ago for $5,200 and is fully depreciated.
- Dave sold an apartment building for $200,000 on September 1. The rental property was purchased on September 1, 2007, for $150,000 and was being depreciated over a 27.5-year life using the straight-line method. At the date of sale, the adjusted basis was $124,783.
- Dave's personal yacht was stolen on September 5. The yacht had been purchased in August at a cost of $25,000. The fair market value immediately preceding the theft was $19,600. Dave was insured for 50% of the original cost, and he received $12,500 on December 1.
- Dave sold a Buick on May 1 for $9,600. The vehicle had been used exclusively for personal purposes. It was purchased on September 1, 2006, for $20,800.
- Dave's trampoline stretching machine (owned two years) was stolen on May 5, but the business's insurance company will not pay any of the machine's value because Dave failed to pay the insurance premium. The machine had a fair market value of $8,000 and an adjusted basis of $6,000 at the time of theft.
- Dave had AGI of $402,000 from sources other than those described above.
- Dave has no nonrecaptured § 1231 lookback losses.

a. For each transaction, what are the amount and nature of recognized gain or loss?
b. What is Dave's 2010 AGI?

CRITICAL THINKING

30. **LO.6, 7** A business building on which straight-line depreciation of $13,000 was taken is sold on the installment basis for $100,000 with $20,000 down and four yearly installments of $20,000 plus interest. The adjusted basis for the building is $35,000 at the time of the sale. The building had been held for more than 12 months. What are the amount and nature of the recognized gain?

31. **LO.7** Nicholas owns business equipment with a $155,000 adjusted basis; he paid $200,000 for the equipment, and it is currently worth $173,000. Nicholas dies suddenly, and his son Alvin inherits the property. What is Alvin's basis for the property, and what happens to the § 1245 depreciation recapture potential?

Bridge DISCIPLINE

1. Using an online research service, find the audited financial statements of a major U.S. corporation.
   a. List some of the items that the corporation reports as having different treatment for tax and financial accounting purposes. These items often are mentioned in the footnotes to the statements.
   b. List two or more such items that seem to increase the taxpayer's after-tax income and two or more that seem to decrease it.

RESEARCH PROBLEMS

Note: Solutions to Research Problems can be prepared by using the **Checkpoint® Student Edition** online research product, which is available to accompany this text. It is also possible to prepare solutions to the Research Problems by using tax research materials found in a standard tax library.

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Research Problem 1. Clyde had worked for many years as the chief executive of Red Industries, Inc., and had also been a major shareholder. Clyde and the company had a falling out, and Clyde was terminated. Clyde and Red executed a document under which Clyde's stock in Red would be redeemed and Clyde would agree not to compete against Red in its geographic service area. After extensive negotiations between the parties, Clyde agreed to surrender his Red stock in exchange for $600,000. Clyde's basis in his shares was $143,000, and he had held the shares for 17 years. The agreement made no explicit allocation of any of the $600,000 to Clyde's agreement not to compete against Red. How should Clyde treat the $600,000 payment on his 2010 tax return?

DECISION MAKING

Research Problem 2. Ali owns 100 shares of Brown Corporation stock. He purchased the stock at five different times and at five different prices per share as indicated.

Share Block	Number of Shares	Per Share Price	Purchase Date
A	10	$60	10/10/95
B	20	20	8/11/96
C	15	15	10/24/96
D	35	30	4/23/98
E	20	25	7/28/98

On April 28, 2010, Ali will sell 40 shares of Brown stock for $40 per share. All of Ali's shares are held by his stockbroker. The broker's records track when the shares were purchased. May Ali designate the shares he sells, and, if so, which shares should he sell? Assume Ali wants to maximize his gain because he has a capital loss carryforward.

Research Problem 3. Jonas is holding an option on vacant land. He paid $40,000 for the option on November 3, 2009, and the option expires on December 31, 2010. If Jonas exercised the option, he would hold the vacant land for investment. Jonas does not intend to exercise the option, but could sell it for $2,000 on October 20, 2010. What are Jonas's tax consequences from either (a) selling the option or (b) letting the option expire?

Partial list of research aids:
§ 1234 and Reg. § 1.1234–1.

COMMUNICATIONS

Research Problem 4. Clean Corporation runs a chain of dry cleaners. Borax is used heavily in Clean's dry cleaning process and has been in short supply several times in the past. Several years ago, Clean Corporation bought a controlling interest in Dig Corporation—a borax mining concern—to assure Clean of a continuous supply of borax if another shortage developed. Clean has just sold the stock at a loss because Dig is in difficult financial straits and because Clean has obtained an alternative source of borax. What is the nature of Clean's loss on the disposition of the Dig Corporation stock? Write a letter to the controller, Salvio Guitterez, that contains your advice and prepare a memo for the tax files. The mailing address of Clean Corporation is 4455 Whitman Way, San Mateo, CA 44589.

Research Problem 5. Walter is both a real estate developer and the owner and manager of residential rental real estate. Walter is retiring and is going to sell both the land he is holding for future development and the rental properties he owns. Straight-line depreciation was used to depreciate the rental real estate. The rental properties will be sold at a substantial loss, and the development property will be sold at a substantial gain. What is the nature of these gains and losses?

Partial list of research aids:
§§ 1221 and 1231.
Zane R. Tollis, 65 TCM 1951, T.C.Memo. 1993–63.

Research Problem 6. In 2006, a taxpayer made leasehold improvements that were eligible for a 15-year MACRS life. Straight-line depreciation was taken on the improvements. Will these improvements be subject to either § 1245 or § 1250 depreciation recapture if they are eventually disposed of at a recognized gain?



Use the tax resources of the Internet to address the following questions. Do not restrict your search to the Web, but include a review of newsgroups and general reference materials, practitioner sites and resources, primary sources of the tax law, chat rooms and discussion groups, and other opportunities.

COMMUNICATIONS

Research Problem 7. Summarize tax planning strategies related to each of the following topics that are presented on the Internet by tax advisers looking for clients. Send your findings in an e-mail to your instructor.

a. A strategy for maximizing gains that are eligible for the 0%/15% alternative tax rate rather than the 25% rate.
b. A strategy for maximizing gains that are eligible for the 0%/15% alternative tax rate rather than the 28% rate.

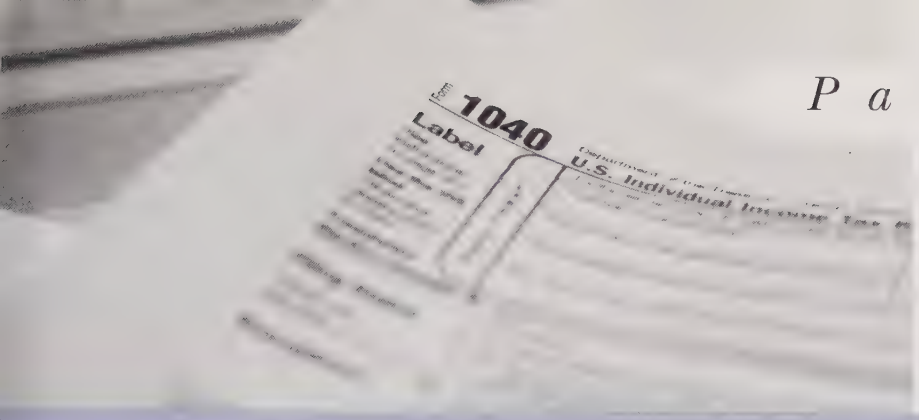
COMMUNICATIONS

Research Problem 8. Find a website that discusses the income tax in Germany. Determine whether Germany has an alternative tax on net long-term capital gains similar to that in the United States. Summarize your findings in an e-mail to your instructor.

Research Problem 9. Investors are flooded with performance data and rankings of mutual funds. The "tax efficiency" of these funds is much more difficult to determine, even though this information often has an enormous impact on taxable accounts (i.e., non-retirement-oriented accounts). Examine various websites to determine recent distribution history of mutual funds and compare their pre-tax and after-tax performance data to assess the impact of this information on investment planning.

Research Problem 10. Go to the IRS website and download a Form 4797 and its instructions. Use the form to complete Problem 27.

Research Problem 11. Find a state website that has tax forms and instructions for that state. Let's call that state "X." Find a discussion in those sources that reveals whether state X taxes gains from the sale of real estate that is located in state Y when the taxpayer is an individual and is a full-time resident of state X.



Part 4

Business Entities

CHAPTER 9 Corporations: Organization, Capital Structure, and Operating Rules

CHAPTER 10 Corporations: Earnings & Profits and Distributions

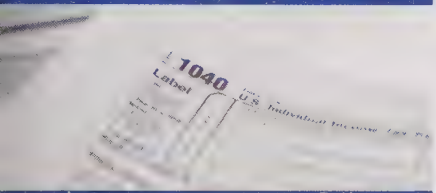
CHAPTER 11 Partnerships and Limited Liability Entities

CHAPTER 12 S Corporations

The materials in Parts 1 through 3 have dealt with tax concepts that generally are taxpayer neutral with respect to the different types of business entities. Some of these tax concepts are equally applicable to individual taxpayers. Part 4 focuses on the different types of business entities and includes a life cycle coverage of formation, operations, and termination. The specific business entities covered are the C corporation, the S corporation, the partnership, and the LLC.

CHAPTER 9

Corporations: Organization, Capital Structure, and Operating Rules



TAX *Talk*

Taxes owing to the Government . . . are the price that business has to pay for protection and security.

—Benjamin N. Cardozo

LEARNING OBJECTIVES

After completing Chapter 9, you should be able to:

LO.1 Recognize major **tax and nontax considerations associated with the corporate form** of business. **(pp. 9-3 to 9-8)**

LO.2 Identify the tax consequences of **incorporating and transferring assets to controlled corporations**. **(pp. 9-8 to 9-15)**

LO.3 Understand the special rules that apply **when a corporation assumes a shareholder's liability**. **(pp. 9-15 to 9-18)**

LO.4 Recognize the **basis issues** relevant to the shareholder and the corporation. **(pp. 9-18 to 9-24)**

LO.5 Understand the tax aspects of the **capital structure** of a corporation. **(pp. 9-24 to 9-25)**

LO.6 Recognize the tax differences between **debt and equity investments**. **(pp. 9-25 to 9-27)**

LO.7 Understand the **tax rules unique to corporations**. **(pp. 9-28 to 9-31)**

LO.8 Compute the **corporate income tax**. **(pp. 9-31 to 9-32)**

LO.9 Explain the rules unique to computing the tax of **related corporations**. **(pp. 9-32 to 9-34)**

LO.10 Describe the **reporting process** for corporations. **(pp. 9-34 to 9-38)**

OUTLINE

9.1 An Introduction to Corporate Tax, 9-3
Double Taxation of Corporate Income, 9-3
Comparison of Corporations and Other Forms of Doing Business, 9-5
Nontax Considerations, 9-7
Limited Liability Companies, 9-7
Entity Classification, 9-8
9.2 Organization of and Transfers to Controlled Corporations, 9-8
In General, 9-8
Transfer of Property, 9-10
Stock, 9-11
Control of the Corporation, 9-11
Assumption of Liabilities—§ 357, 9-15
Basis Determination and Other Issues, 9-18
Recapture Considerations, 9-23
9.3 Capital Structure of a Corporation, 9-24
Capital Contributions, 9-24
Debt in the Capital Structure, 9-25
9.4 Corporate Operations, 9-28
Deductions Available Only to Corporations, 9-28
Determining the Corporate Income Tax Liability, 9-31
Tax Liability of Related Corporations, 9-32
Controlled Groups, 9-33
9.5 Procedural Matters, 9-34
Filing Requirements for Corporations, 9-34
Estimated Tax Payments, 9-34
Schedule M–1—Reconciliation of Taxable Income and Financial Net Income, 9-35
Schedule M–3—Net Income (Loss) Reconciliation for Corporations with Total Assets of $10 Million or More, 9-37
Effect of Taxes on Financial Statements, 9-38
9.6 Summary, 9-38

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GROWING INTO THE CORPORATE FORM

Amber has operated her business as a sole proprietorship since it was formed 10 years ago. Now, however, she has decided to incorporate the business because the corporate form offers several important nontax advantages including limited liability. Also, the incorporation would enable her husband, Jimmy, to become a part owner in the business. Amber expects to transfer her business assets in exchange for her corporate interest, while Jimmy will provide accounting and legal services for his interest. Amber's sole proprietorship assets available for transfer to the new corporation are:

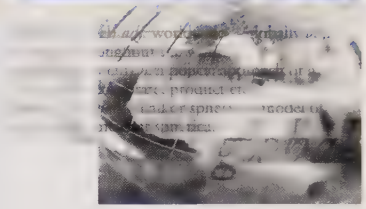
	Adjusted Basis	Fair Market Value
Accounts receivable	$ –0–	$ 25,000
Building	50,000	200,000
Other assets	150,000	300,000
	$200,000	$525,000

Aware of the problem of double taxation associated with operating as a regular corporation, Amber is considering receiving some corporate debt at the time of the incorporation. The interest expense on the debt will then provide a deduction for the corporation. Amber's main concern is whether the incorporation will be a taxable transaction. Can the transaction be structured to avoid tax? **Read the chapter and formulate your response.**

Business operations may be conducted in a number of different forms. As with many business decisions, consideration must be given to the tax consequences of choosing a particular business entity. This chapter deals with the unique tax consequences of operating an entity as a regular corporation, including:

- Classification of the entity as a corporation.
- The tax consequences to the shareholders and the corporation upon the formation of the corporation.

GLOBAL *Tax Issues*



Choice of Organizational Form When Operating Overseas

When the management of a corporation decides to expand its business by establishing a presence in a foreign market, the new business venture may take one of several organizational forms. As each form comes with its respective advantages and disadvantages, making the best choice can be difficult.

One common approach is to conduct the foreign activity as a *branch* operation of the U.S. corporation. The foreign branch is not a separate legal entity, but a division of the U.S. corporation established overseas. As a result, any gains and losses produced by the foreign unit are included in the corporation's overall financial results.

Another possibility is to organize the foreign operations as a *subsidiary* of the U.S. parent corporation. If this route is chosen, the subsidiary can be either a *domestic* subsidiary (i.e., organized in the United States) or a *foreign* subsidiary (organized under the laws of a foreign country).

One fundamental tax difference between these two approaches is that the gains and losses of a domestic subsidiary may be consolidated with the operations of the U.S. parent, while the operations of a foreign subsidiary cannot. Thus, the use of a domestic subsidiary to conduct foreign operations will yield generally the same final result as the use of a branch. With both approaches, the financial statements of the U.S. parent reflect the results of its worldwide operations.

- The capital structure of the corporation.
- Determination of the corporate income tax liability.
- Corporate tax filing requirements.

9.1 An Introduction to Corporate Tax

LO.1

Recognize major tax and nontax considerations associated with the corporate form of business.

Corporations are governed by Subchapter C or Subchapter S of the Internal Revenue Code. Those governed by Subchapter C are referred to as **C corporations** or **regular corporations**. Corporations governed by Subchapter S are referred to as **S corporations**.

S corporations, which generally do not pay Federal income tax, are similar to partnerships in that net profit or loss flows through to the shareholders to be reported on their separate returns. Also like partnerships, S corporations do not aggregate all income and expense items in computing net profit or loss. Certain items flow through to the shareholders and retain their separate character when reported on the shareholders' returns. The S corporation net profit (loss) and the separately reported items are allocated to the shareholders according to their stock ownership interests. See Chapter 12 for detailed coverage of S corporations.

DOUBLE TAXATION OF CORPORATE INCOME

Unlike proprietorships, partnerships, and S corporations, C corporations are subject to an entity-level Federal income tax. This results in what is known as a *double taxation* effect. A C corporation reports its income and expenses on Form 1120. The corporation computes tax on the taxable income reported on Form 1120 using the rate schedule applicable to corporations (refer to the rate schedule inside the front cover of this text). When a corporation distributes its income, the corporation's shareholders report dividend income on their own tax returns. Thus, income that has already been taxed at the corporate level is also taxed at the shareholder level. The effects of double taxation are illustrated in Examples 1 and 2.

EXAMPLE 1

Lavender Corporation has taxable income of $100,000 in 2010. It pays corporate tax of $22,250 (refer to the corporate tax rate schedule on the inside front cover of this text). This leaves $77,750, all of which is distributed as a dividend to Mike, a 43-year-old

TAX FACTS

Corporations' Reporting Responsibilities

Like individuals, corporations are required to report their taxable income and other financial information to the IRS on an annual basis. The forms used depend on the type and size of the corporation. Based on projections, the IRS expects to receive approximately 7.1 million corporate income tax returns during the 2011 filing season.

Type of Corporation	Form	Percentage
C Corporation	1120	30.1%
C Corporation	Others	4.1
S Corporation	1120S	65.8
		100.0%

Interestingly, over 33 percent of C and S corporations are expected to submit their returns electronically.

Source: Fiscal Year Return Projections for the United States: 2009–2016, IRS, Document 6292, Spring 2009 Update, Table 1.

single individual and the corporation's sole shareholder. Mike has no income sources other than Lavender Corporation. Mike has taxable income of $68,400 ($77,750 − $5,700 standard deduction − $3,650 personal exemption). He pays tax at the preferential rate applicable to dividends received by individuals. His tax is $5,160 [($34,000 × 0%) + ($34,400 × 15%)]. The combined tax on the corporation's net profit is $27,410 ($22,250 paid by the corporation + $5,160 paid by the shareholder). ■

EXAMPLE 2

Assume the same facts as in Example 1, except that the business is organized as a sole proprietorship. Mike reports the $100,000 profit from the business on his tax return. He has taxable income of $90,650 ($100,000 − $5,700 standard deduction − $3,650 personal exemption) and pays tax of $19,091. Therefore, operating the business as a sole proprietorship results in a tax *savings* of $8,319 in 2010 ($27,410 from Example 1 − $19,091). ■

In many cases, the tax burden will be greater if the business is operated as a corporation (as in Example 1), but sometimes operating as a corporation can result in tax savings, as illustrated in Examples 3 and 4.

EXAMPLE 3

In 2010, Tan Corporation files Form 1120 reporting taxable income of $100,000. The corporation pays tax of $22,250 and distributes the remaining $77,750 as a dividend to Carla, the sole shareholder of the corporation. Carla has income from other sources and is in the top individual tax bracket of 35% in 2010. As a result, she pays tax of $11,663 ($77,750 × 15% rate on dividends) on the distribution. The combined tax on the corporation's earnings is $33,913 ($22,250 paid by the corporation + $11,663 paid by the shareholder). ■

EXAMPLE 4

Assume the same facts as in Example 3, except that the business is a sole proprietorship. Carla reports the $100,000 profit from the business on her tax return and pays tax of $35,000 ($100,000 × 35% marginal rate). Therefore, operating the business as a sole proprietorship results in a tax *cost* of $1,087 in 2010 ($35,000 − $33,913 tax from Example 3). ■

The conclusions reached in these examples cannot be extended to all decisions about a form of business organization, as each specific set of facts and circumstances requires a thorough analysis of the tax factors. Further, the effect of other taxes (e.g., payroll and self-employment taxes, state income and franchise taxes) must be considered in such an analysis.

Taxation of Dividends

As noted earlier, the income of a C corporation is subject to double taxation—once at the corporate level when it is earned and again at the shareholder level when it is distributed as dividends. Double taxation stems, in part, from the fact that dividend distributions are not deductible by the corporation. Shareholders of closely held corporations frequently attempt to circumvent this disallowance by disguising a dividend distribution as some other purported transaction. One of the more common ways of disguising dividend distributions is to pay excessive compensation to shareholder-employees of a closely held corporation. The IRS scrutinizes compensation and other economic transactions (e.g., loans, leases, sales) between shareholders and closely held corporations to ensure that payments are reasonable in amount. (See Chapter 10 for more discussion on disguised dividends.)

Double taxation also stems from the fact that dividend distributions are taxable to the shareholders. Historically, dividend income has been taxed at the same rates as ordinary income. However, to alleviate some of the double taxation effect, Congress reduced the tax rate applicable to dividend income of individuals for years after 2002. Qualified dividend income is currently taxed at the same preferential rate as long-term capital gains—15 percent (0 percent for taxpayers in the bottom two tax brackets). The 0 percent rate was 5 percent instead of zero percent for 2007 and prior years. The preferential rate on dividend income is set to expire for years after 2010.

COMPARISON OF CORPORATIONS AND OTHER FORMS OF DOING BUSINESS

Chapter 15 presents a detailed comparison of sole proprietorships, partnerships, S corporations, and C corporations as forms of doing business. However, it is appropriate at this point to consider some of the tax and nontax factors that favor corporations over other business entities.

Consideration of tax factors requires an examination of the corporate rate structure. The income tax rate schedule applicable to corporations is reproduced on the inside front cover of the text. As this schedule shows, the marginal tax rates for corporations range from 15 percent to 39 percent. In comparison, the marginal tax rates for individuals range from 10 percent to 35 percent. The corporate form of doing business presents tax savings opportunities when the applicable corporate marginal rate is lower than the applicable individual marginal rate.

EXAMPLE 5

Susanna, an individual taxpayer in the 35% marginal tax rate bracket, can generate $100,000 of additional taxable income in the current year. If the income is taxed to Susanna, the associated tax is $35,000 ($100,000 × 35%). If, however, Susanna is able to shift the income to a newly created corporation, the corporate tax is $22,250. Thus, by taking advantage of the lower corporate marginal tax rates, a tax *savings* of $12,750 ($35,000 − $22,250) is achieved. ■

Any attempt to arbitrage the difference between the corporate and individual marginal tax rates also must consider the double taxation effect. When the preferential rate for dividend income is considered, however, tax savings opportunities still exist.

EXAMPLE 6

Assume in Example 5 that the corporation distributes all of its after-tax earnings to Susanna as a dividend. The dividend results in tax of $11,663 [($100,000 − $22,250) × 15%] to Susanna. Thus, even when the double taxation effect is considered, the



Bridge to Finance

Investment brokers and promoters often try to entice individuals to invest their disposable income in ventures designed to produce handsome returns. In most situations, the type of business entity in which the funds are invested takes the form of a "flow-through" entity, such as a limited partnership. Such investment ventures rarely operate as regular corporations.

A limited partnership is the favored investment vehicle for several reasons. One of the most significant reasons is that the investors who become limited partners are protected from exposure to unlimited liability. In addition, any operating losses of the entity (which may be expected in the venture's early years) flow through to the partners and, as a result, may provide an immediate tax benefit on the partners' returns. Another major advantage of the partnership form, in contrast to the corporate form, is that the business earnings are subject to only one level of tax—at the partner or investor level. If the investments were housed in a corporation, a tax would be levied first on the corporate earnings and then at the investor level when the corporation makes distributions to the shareholders.

combined tax burden of $33,913 ($22,250 paid by the corporation + $11,663 paid by the shareholder) represents a tax *savings* of $1,087 when compared to the $35,000 of tax that results when the $100,000 of income is subject to Susanna's 35% marginal rate. ■

Examples 5 and 6 ignore other tax considerations that also must be considered in selecting the proper form of doing business, but they illustrate the tax savings that can be achieved by taking advantage of tax rate differentials. Some of the other tax considerations that could affect the selection of a business form include the character of business income, the expectation of business losses, payroll taxes, and state taxes.

All income and expense items of a proprietorship retain their character when reported on the proprietor's tax return. In the case of a partnership or S corporation, separately reported items (e.g., charitable contributions and long-term capital gains) retain their character when passed through to the partners or shareholders, respectively. However, the tax attributes of income and expense items of a C corporation do not pass through the corporate entity to the shareholders. As a result, if the business is expected to generate tax-favored income (e.g., tax-exempt income or long-term capital gains), one of the other (non-C corporation) forms of business may be desirable.

Losses of a C corporation are treated differently than losses of a proprietorship, partnership, or S corporation. A loss incurred by a proprietorship may be deductible by the owner, because all income and expense items are reported by the proprietor. Partnership and S corporation losses are passed through the entity and may be deductible by the partners or shareholders. C corporation losses, however, have no effect on the taxable income of the shareholders. Therefore, one of the non-C corporation forms of business may be desirable if business losses are anticipated.

EXAMPLE 7

Franco plans to start a business this year. He expects the business will incur operating losses for the first three years and then become highly profitable. Franco decides to operate as an S corporation during the loss period because the losses will flow through and be deductible on his personal return. When the business becomes profitable, he intends to switch to C corporation status. ■

Employment taxes must be factored into any analysis of a business form. The net income of a proprietorship is subject to the self-employment tax, as are some partnership allocations of income to partners. In the alternative, wages paid to a shareholder-employee of a corporation (C or S) are subject to payroll taxes. The combined corporation-employee payroll tax burden should be compared with the self-employment

tax associated with the proprietorship and partnership forms of business. This analysis should include the benefit of the deduction available to a corporation for payroll taxes paid.

State taxation also must be considered in the selection of a business form. At the entity level, state corporate income taxes and/or franchise taxes are applicable for businesses formed as corporations. Although no entity-level Federal income tax is typically assessed on S corporations, limited liability companies (LLCs), or partnerships, a few states impose a corporate income tax or franchise tax on such business forms. Consideration of state taxation when selecting a business form is particularly relevant for businesses that operate in more than one state. (See Chapter 13 for a discussion of the taxation of multistate corporations.) At the owner level, the income of sole proprietorships, S corporations, and partnerships (including most LLCs) is subject to state individual income taxation. Similarly, dividend income from corporate distributions is subject to state income taxation and without any rate preference for such income.

NONTAX CONSIDERATIONS

Nontax considerations will sometimes override tax considerations and lead to the conclusion that a business should be operated as a corporation. The following are some of the more important nontax considerations:

- Sole proprietors and general partners in partnerships face the danger of *unlimited liability*. That is, creditors of the business may file claims not only against the assets of the business but also against the *personal* assets of proprietors or general partners. State corporate law protects shareholders from claims against their personal assets for corporate debts.
- The corporate form of business can provide a vehicle for raising large amounts of capital through widespread stock ownership. Most major businesses in the United States are operated as corporations.
- Shares of stock in a corporation are freely transferable, whereas a partner's sale of his or her partnership interest is subject to approval by the other partners.
- Shareholders may come and go, but a corporation can continue to exist. Death or withdrawal of a partner, on the other hand, may terminate the existing partnership and cause financial difficulties that result in dissolution of the entity. Thus, *continuity of life* is a distinct advantage of the corporate form of doing business.
- Corporations have *centralized management*. All management responsibility is assigned to a board of directors, which appoints officers to carry out the corporation's business. Partnerships, by contrast, may have decentralized management, in which every partner has a right to participate in the organization's business decisions. **Limited partnerships**, though, may have centralized management. Centralized management is essential for the smooth operation of a widely held business.

LIMITED LIABILITY COMPANIES

The **limited liability company (LLC)** has proliferated greatly in recent years, particularly since 1988 when the IRS first ruled that it would treat qualifying LLCs as partnerships for tax purposes. All 50 states and the District of Columbia have passed laws that allow LLCs, and thousands of companies have chosen LLC status. As with a corporation, operating as an LLC allows its owners to avoid unlimited liability, which is a primary *nontax* consideration in choosing this form of business organization. The tax advantage of LLCs is that qualifying businesses may be treated as partnerships for tax purposes, thereby avoiding the problem of double taxation associated with regular corporations.

Some states allow an LLC to have centralized management, but not continuity of life or free transferability of interests. Other states allow LLCs to adopt any or all of

the corporate characteristics of centralized management, continuity of life, and free transferability of interests. The comparison of business entities in Chapter 15 includes a discussion of LLCs.

ENTITY CLASSIFICATION

In 1996, the IRS issued its so-called **check-the-box Regulations**.[1] The Regulations enable taxpayers to choose the tax status of a business entity without regard to its corporate (or noncorporate) characteristics. These rules simplified tax administration considerably and eliminated much of the litigation that arose under prior law.

Under the check-the-box rules, entities with more than one owner can elect to be classified as either a partnership or a corporation. An entity with only one owner can elect to be classified as a sole proprietorship or as a corporation. In the event of default (i.e., no election is made), multi-owner entities are classified as partnerships and single-person businesses as sole proprietorships.

The election is not available to entities that are actually incorporated under state law or to entities that are required to be taxed as corporations under Federal law (e.g., certain publicly traded partnerships). Otherwise, LLCs are not treated as being incorporated under state law. Consequently, they can elect either corporation or partnership status.



In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

Tax Planning Strategies **RELATED GROUPS MAY UTILIZE CHECK-THE-BOX REGULATIONS**

FRAMEWORK FOCUS: THINKING OUTSIDE THE FRAMEWORK

The check-the-box Regulations allow a single-owner eligible entity to be treated as a corporation or a division. Since LLCs are eligible entities, a C corporation that owns 100 percent of an LLC can treat the LLC as a division. At the same time, the parent corporation can enjoy the benefit of limited liability in the LLC operations. By electing division treatment, the income of the LLC flows directly to the parent corporation for tax purposes. Consequently, the parent corporation is able to avoid detailed and complex consolidated return Regulations and filing requirements.

9.2 ORGANIZATION OF AND TRANSFERS TO CONTROLLED CORPORATIONS

LO.2

Identify the tax consequences of incorporating and transferring assets to controlled corporations.

IN GENERAL

Property transactions normally produce tax consequences if a gain or loss is realized. As a result, unless special provisions in the Code apply, a transfer of property to a corporation in exchange for stock is a taxable transaction. The amount of gain or loss is measured by the difference between the fair market value of the stock received and the tax basis of the property transferred.

The Code, however, permits nonrecognition of gain or loss in limited circumstances. For example, when a taxpayer exchanges some of his or her property for other property of a like kind, § 1031 provides that gain (or loss) realized on the exchange is not recognized because a substantive change in the taxpayer's investment has not occurred. The deferral of gain or loss is accomplished by calculating a

[1]Reg. §§ 301.7701–1 through –4, and –7.

substituted basis for the like-kind property received. With this substituted basis, the realized gain or loss associated with the property given up is ultimately recognized when the property received in the exchange is sold.

In a similar fashion, § 351 provides that gain or loss is not recognized upon the transfer of property to a corporation in exchange for stock. The nonrecognition of gain or loss under § 351 reflects the principle that gain should not be recognized when a taxpayer's investment has not substantively changed. For example, when a business is incorporated, the owner's economic status remains the same; only the *form* of the investment has changed. The investment in the business assets carries over to an investment in corporate stock. When only stock in the corporation is received, the shareholder is hardly in a position to pay a tax on any realized gain. As noted later, however, when the taxpayer receives property other than stock (i.e., cash or other "boot") from the corporation, some or all of the realized gain is recognized.

The same principles govern the nonrecognition of gain or loss under § 1031 and § 351. The concept of nonrecognition of gain or loss, present in both provisions, causes gain or loss to be deferred until a substantive change in the taxpayer's investment occurs (such as a sale to or a taxable exchange with third parties). This approach is justified under the wherewithal to pay concept discussed in Chapter 1. A further justification for the nonrecognition of gain or loss provisions under § 351 is that tax rules should not impede the exercise of sound business judgment (e.g., choice of the corporate form of doing business).

EXAMPLE 9

Ron is considering incorporating his sole proprietorship. He is concerned about his personal liability for the obligations of the business. Ron realizes that if he incorporates, he will be liable only for the debts of the business that he has personally guaranteed. If Ron incorporates his business, the following assets will be transferred to the corporation:

	Tax Basis	Fair Market Value
Cash	$ 10,000	$ 10,000
Furniture and fixtures	20,000	60,000
Land and building	240,000	300,000
	$270,000	$370,000

In exchange, Ron will receive stock in the newly formed corporation worth $370,000. Without the nonrecognition provisions of § 351, Ron would recognize a taxable gain of $100,000 ($370,000 − $270,000) on the transfer. Under § 351, however, Ron does not recognize any gain because his economic status has not changed. Ron's investment in the assets of his sole proprietorship ($270,000) carries over to his investment in the incorporated business, which is now represented by his ownership of stock in the corporation. Thus, § 351 provides for tax neutrality on the initial incorporation of Ron's sole proprietorship. ■

When a taxpayer participates in a like-kind exchange, gain is deferred to the extent that the taxpayer receives like-kind property. The taxpayer must recognize some or all of the realized gain when receiving "boot" (i.e., property of an unlike kind). For example, if a taxpayer exchanges a truck used in a business for another truck to be used in the business and also receives cash, the taxpayer has the wherewithal to pay an income tax on the cash involved. Further, the taxpayer's economic status has changed to the extent of the cash (not like-kind property) received. Thus, "realized" gain on the exchange is recognized to the extent of the cash received. In like manner, if a taxpayer transfers property to a corporation and receives money or property other than stock, § 351(b) provides that gain is recognized to the extent of the lesser of the gain realized or the boot received (the amount of money and the fair market value of other property received). Gain is characterized according to the type of asset transferred.[2]

[2]Rev.Rul. 68–55, 1968–1 C.B. 140.

Loss on a § 351 transaction is never recognized. The nonrecognition of gain or loss is accompanied by a substituted basis in the shareholder's stock.[3]

EXAMPLE 9

Abby and Bill form White Corporation. Abby transfers property with an adjusted basis of $30,000 and a fair market value of $60,000 for 50% of White's stock. Bill transfers property with an adjusted basis of $70,000 and a fair market value of $60,000 for the remaining 50% of the stock. The transfers qualify under § 351. Abby has a deferred gain of $30,000, and Bill has a deferred loss of $10,000. Both have a substituted basis in the stock of White Corporation. Abby has a basis of $30,000 in her stock, and Bill has a basis of $70,000 in his stock. Assume instead that Abby receives stock and cash of $10,000. Abby would recognize a gain of $10,000. ■

Section 351 is *mandatory* if a transaction satisfies the provision's requirements. There are three requirements for nonrecognition of gain or loss: (1) *property* is transferred (2) in exchange for *stock* and (3) the transferors must be in *control* of the transferee corporation immediately after the transfer. These three requirements are discussed below.

TRANSFER OF PROPERTY

Questions have arisen concerning what constitutes **property** for purposes of § 351. The Code specifically excludes services rendered from the definition of property. With this exception, the definition of property is comprehensive. For example, along with plant and equipment, unrealized receivables for a cash basis taxpayer and installment obligations are considered property.[4] The transfer of an installment obligation in a transaction qualifying under § 351 is not a disposition of the installment obligation. Thus, gain is not recognized to the transferor. Secret processes and formulas, as well as secret information in the general nature of a patentable invention, also qualify as property under § 351.[5]

Services are not considered to be property under § 351 for a critical reason. A taxpayer must report as income the fair market value of any consideration received as compensation for services rendered.[6] Thus, if a taxpayer receives stock in a corporation as consideration for rendering services to the corporation, the taxpayer has taxable income. In this case, the amount of income recognized by the taxpayer is equal to the fair market value of the stock received. The taxpayer's basis in the stock received is its fair market value.

EXAMPLE 10

Ann and Bob form Brown Corporation and transfer the following consideration:

	Consideration Transferred		
	Basis to Transferor	Fair Market Value	Number of Shares Issued
From Ann:			
Personal services rendered to Brown Corporation	$ –0–	$20,000	200
From Bob:			
Installment obligation	5,000	40,000	
Inventory	10,000	30,000	800
Secret process	–0–	10,000	

The value of each share in Brown Corporation is $100.[7] Ann has taxable income of $20,000 on the transfer because services do not qualify as "property." She has a basis of

[3] § 358(a). See the discussion preceding Example 28.

[4] *Hempt Brothers, Inc. v. U.S.*, 74–1 USTC ¶9188, 33 AFTR 2d 74–570, 490 F.2d 1172 (CA–3, 1974), and Reg. § 1.453–9(c)(2).

[5] Rev.Rul. 64–56, 1964–1 C.B. 133; Rev.Rul. 71–564, 1971–2 C.B. 179.

[6] §§ 61 and 83.

[7] The value of closely held stock normally is presumed to be equal to the value of the property transferred.

$20,000 in her 200 shares of stock in Brown (i.e., Ann is treated as having bought some of the Brown stock by rendering services). Bob recognizes no gain on the transfer because all of the consideration he transferred to Brown qualifies as "property" and he has "control" of Brown after the transfer. (See the discussion concerning control below.) Bob has a substituted basis of $15,000 in the Brown stock. ■

If property is transferred to a corporation in exchange for any property other than stock, the property received constitutes boot. The boot is taxable to the transferor-shareholder to the extent of any realized gain.[8]

STOCK

Generally, the term "stock" needs no clarification. It includes both common stock and most preferred stock. However, the Regulations state that the term "stock" does not include stock rights and stock warrants.[9] In addition, it does not include "nonqualified preferred stock," which possesses many of the attributes of debt.[10]

Thus, any corporate debt or **securities** (i.e., long-term debt, such as bonds) are treated as boot because they do not qualify as stock. Therefore, the receipt of debt in exchange for the transfer of appreciated property to a controlled corporation causes recognition of gain.

CONTROL OF THE CORPORATION

For a transaction to qualify as nontaxable under § 351, the transferor(s) of the property must be in **control** of the corporation immediately after the exchange. Control means that the person or persons transferring *property* must have at least an 80 percent stock ownership in the corporation. The property transferors must own stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote *and* at least 80 percent of the total *number* of shares of all other classes of stock.[11]

Control Immediately after the Transfer

Immediately after the exchange, the property transferors must control the corporation. Control can apply to a single person or to several taxpayers if they are all parties to an integrated transaction. The Regulations provide that when more than one person is involved, the exchange does not necessarily require simultaneous exchanges by two or more persons. The Regulations do, however, require that the rights of the parties (i.e., those transferring property to the corporation) be previously set out and determined. Also, the agreement to transfer property should be executed "with an expedition consistent with orderly procedure."[12]

If two or more persons transfer property to a corporation for stock, the transfers should occur close together in time and should be made in accordance with an agreement among the parties.

EXAMPLE 11

Jack exchanges property with a basis of $60,000 and a fair market value of $100,000 for 70% of the stock of Gray Corporation. The other 30% is owned by Jane, who acquired it several years ago. The fair market value of Jack's stock is $100,000. Jack recognizes a taxable gain of $40,000 on the transfer because he does not have control immediately after the exchange and his transaction cannot be integrated with Jane's for purposes of the control requirement. ■

[8] § 351(b).

[9] Reg. § 1.351–1(a)(1)(ii).

[10] § 351(g). Examples of nonqualified preferred stock include preferred stock that is redeemable within 20 years of issuance and whose dividend rate is based on factors other than corporate performance. Therefore, gain is recognized up to the fair market value of the nonqualified preferred stock received. Loss may be recognized when the transferor receives *only* nonqualified preferred stock (or nonqualified preferred stock and other boot) in exchange for property. See also Reg. § 1.351–1(a)(1)(ii).

[11] § 368(c). Nonqualified preferred stock is treated as stock, and not boot, for purposes of this control test.

[12] Reg. § 1.351–1(a)(1).

EXAMPLE 12

Lana, Leo, and Lori incorporate their respective businesses by forming Green Corporation. Lana exchanges her property for 300 shares in Green on January 8, 2010. Leo exchanges his property for 400 shares in Green on January 14, 2010, and Lori exchanges her property for 300 shares in Green on March 5, 2010. The three exchanges are part of a prearranged plan, so the control requirement is met. The nonrecognition provisions of § 351 apply to all of the exchanges. ■

Stock need not be issued to the property transferors in the same proportion as the relative value of the property transferred by each. However, when stock received is not proportionate to the value of the property transferred, the actual effect of the transaction must be properly characterized. For example, in such situations one transferor may actually be making a gift of valuable consideration to another transferor.

EXAMPLE 13

Ron and Shelia, father and daughter, form Oak Corporation. Ron transfers property worth $50,000 in exchange for 100 shares of stock, while Shelia transfers property worth $50,000 for 400 shares of stock. The transfers qualify under § 351 because Ron and Shelia have control of the Oak stock immediately after the transfers of property. However, the implicit gift by Ron to Shelia must be recognized and appropriately characterized. As such, the value of the gift might be subject to the gift tax. ■

Once control has been achieved, it is not necessarily lost if stock received by shareholders in a § 351 exchange is sold or given to persons who are not parties to the exchange shortly after the transaction. However, failure to meet the control requirement might result if a *plan* for the ultimate disposition of the stock existed *before* the exchange.[13]

EXAMPLE 14

Mark and Carl form Black Corporation. They transfer appreciated property to the corporation with each receiving 50 shares of the stock. Shortly after the formation, Mark gives 25 shares to his son. Because Mark was not committed to make the gift, he is considered to own his original shares of Black Corporation stock and, along with Carl, to control Black Corporation "immediately after the exchange." The requirements of § 351 are met, and neither Mark nor Carl is taxed on the exchange. Alternatively, had Mark immediately given 25 shares to a business associate pursuant to a plan to satisfy an outstanding obligation, the formation of Black would be taxable to Mark and Carl because of their lack of control (i.e., Mark and Carl, the property transferors, would own only 75% of the stock). ■

Tax Planning Strategies UTILIZING § 351

FRAMEWORK FOCUS: INCOME AND EXCLUSIONS

Strategy: Avoid Income Recognition.

When using § 351, ensure that all parties transferring property (including cash) receive control of the corporation. Simultaneous transfers are not necessary, but a long period of time between transfers makes the transaction vulnerable to taxation if the transfers are not properly documented as part of a single plan. To do this, the parties should document and preserve evidence of their intentions. Also, it is helpful to have some reasonable explanation for any delay in the transfers.

To meet the requirements of § 351, mere momentary control on the part of the transferor may not suffice if loss of control is compelled by a prearranged agreement.[14]

[13] *Wilgard Realty Co. v. Comm.*, 42–1 USTC ¶9452, 29 AFTR 325, 127 F.2d 514 (CA–2, 1942).

[14] Rev.Rul. 54–96, 1954–1 C.B. 111.

EXAMPLE 15

For many years, Todd operated a business as a sole proprietor employing Linda as manager. To dissuade Linda from quitting and going out on her own, Todd promised her a 30% interest in the business. To fulfill this promise, Todd transferred the business to newly formed Green Corporation in return for all its stock. Immediately thereafter, Todd transfers 30% of the stock to Linda. As a consequence, he no longer meets the 80% control requirement. Section 351 probably does not apply to Todd's transfer to Green Corporation. It appears that Todd was under an obligation to relinquish control. If this preexisting obligation exists, § 351 will not be available to Todd because, as the sole property transferor, he does not have control of Green Corporation. If there is no obligation and the loss of control was voluntary on Todd's part, momentary control would suffice.[15] ■

Be sure that later transfers of property to an existing corporation satisfy the 80 percent control requirement if recognition of gain is to be avoided. Also with respect to later transfers, a transferor's interest cannot be counted if the value of stock received is relatively small compared with the value of stock already owned. Further, the primary purpose of the transfer may not be to qualify other transferors for § 351 treatment.[16]

Transfers for Property and Services

Section 351 treatment is lost if stock is transferred to persons who did not contribute property, causing those who did to lack control immediately after the exchange.

EXAMPLE 16

Kate transfers property with a value of $60,000 and a basis of $5,000 for 600 shares of stock in newly formed Wren Corporation. Brian receives 400 shares in Wren for services rendered to the corporation. Each share of stock is worth $100. Both Kate and Brian have tax consequences on the transaction. Brian is not part of the control group because he does not transfer property for stock. He has ordinary income of $40,000 (400 shares × $100). Kate has a taxable gain of $55,000 [$60,000 (fair market value of the stock in Wren Corporation) − $5,000 (basis in the transferred property)]. Kate is taxed on the exchange because she receives only 60% of the stock in Wren Corporation (i.e., the 80% control test is not satisfied). ■

A person who performs services for the corporation in exchange for stock and also transfers some property is treated as a member of the transferring group. That person is taxed on the value of the stock issued for services but not on the stock issued for property. In such a case, all the stock received by the person transferring both property and services is counted in determining whether the transferors acquired control of the corporation.[17]

EXAMPLE 17

Assume the same facts as in Example 16, except that Brian transfers property worth $30,000 (basis of $3,000) in addition to services rendered to the corporation (valued at $10,000). Now Brian becomes a part of the control group. Kate and Brian together receive 100% of the stock in Wren Corporation. Consequently, § 351 is applicable to the exchanges. Kate has no recognized gain. Brian does not recognize gain on the transfer of the property, but he recognizes ordinary income to the extent of the value of the shares issued for services rendered. Thus, Brian recognizes income of $10,000. ■

Transfers for Services and Nominal Property

To be a member of the group and aid in qualifying all transferors under the 80 percent control test, the person contributing services must transfer property having more than a "relatively small value" compared to the value of services performed. Section 351 will not apply when a small amount of property is transferred and the

[15]Compare *Fahs v. Florida Machine and Foundry Co.*, 48–2 USTC ¶9329, 36 AFTR 1161, 168 F.2d 957 (CA–5, 1948), with *John C. O'Connor*, 16 TCM 213, T.C.Memo. 1957–50, *aff'd* in 58–2 USTC ¶9913, 2 AFTR 2d 6011, 260 F.2d 358 (CA–6, 1958).

[16]Reg. § 1.351–1(a)(1)(ii).

[17]Reg. § 1.351–1(a)(2), Ex. 3.

primary purpose of the transfer is to qualify the transaction under § 351 for concurrent transferors.[18]

EXAMPLE 18

Kim and Eric transfer property to Redbird Corporation, each in exchange for one-third of the stock. Howie receives the other one-third of the stock for services rendered. The transaction will not qualify under § 351 because Howie is not a member of the group transferring property and Kim and Eric together received only $66^2/_3$% of the stock. Thus, the post-transfer control requirement is not met.

Assume instead that Howie also transfers property. Then he is a member of the group, and the transaction qualifies under § 351. Howie is taxed on the value of the stock issued for services, but the remainder of the transaction is tax-free. However, if the property transferred by Howie is of a relatively small value in comparison to the stock he receives for his services, and the primary purpose for transferring the property is to cause the transaction to be tax-free for Kim and Eric, the exchange does not qualify under § 351. Gain or loss is recognized by all parties. ■

The IRS generally requires that before a transferor who receives stock for both property and services can be included in the control group, the value of the property transferred must be at least 10 percent of the value of the services provided.[19] If the value of the property transferred is less than this amount, the IRS will not issue an advance ruling that the exchange meets the requirements of § 351.

EXAMPLE 19

Sara and Rick form White Corporation. Sara transfers land (worth $100,000, basis of $20,000) for 50% of the stock in White. Rick transfers equipment (worth $5,000, adjusted basis of $1,000) and provides services worth $95,000 for 50% of the stock. Rick's stock in White Corporation is unlikely to be counted in determining control for purposes of § 351; thus, the control requirement is not met. None of Rick's stock is counted in determining control because the property he transfers has a nominal value in comparison to the value of the services he renders. Sara recognizes $80,000 of gain on the transfer of the land. She has a basis of $100,000 in her White stock. Rick must recognize income of $95,000 on the transfer for services rendered and a gain of $4,000 for the property transferred. Rick also has a $100,000 basis in his White stock. ■

Transfers to Existing Corporations

Once a corporation is in operation, § 351 also applies to any later transfers of property for stock by either new or existing shareholders.

EXAMPLE 20

Sam and Beth formed Blue Corporation three years ago. Both Sam and Beth transferred appreciated property to Blue in exchange for 500 shares each in the corporation. The original transfers qualified under § 351, and neither Sam nor Beth was taxed on the exchange. In the current year, Sam transfers property (worth $100,000, adjusted basis of $5,000) for 500 additional Blue shares. Sam has a taxable gain of $95,000 on the transfer. The exchange does not qualify under § 351 because Sam does not have 80% control of Blue Corporation immediately after the transfer; he owns 1,000 shares of the 1,500 shares outstanding, or a $66^2/_3$% interest. ■

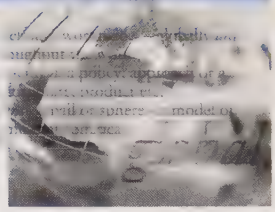
If current shareholders transfer property with a small value relative to the value of stock already owned, a special rule applies (similar to the nominal property rule noted previously). In particular, if the purpose of the transfer is to qualify a transaction under § 351, the ownership of the current shareholders is not counted when determining control. Thus, in the preceding example, if Beth had contributed $200 for one share of stock at the time of Sam's contribution, Beth's ownership would not

[18]Reg. § 1.351–1(a)(1)(ii).

[19]Rev.Proc. 77–37, 1977–2 C.B. 568.

Does § 351 Cover the Incorporation of a Foreign Business?

GLOBAL *Tax Issues*



When a taxpayer wishes to incorporate a business overseas by moving assets across U.S. borders, the deferral mechanism of § 351 applies in certain situations, but not in others. In general, § 351 is available to defer gain recognition when starting up a new corporation outside the United States unless so-called tainted assets are involved. Under § 367, tainted assets, which include assets such as inventory and accounts receivable, are treated as having been sold by the taxpayer prior to the corporate formation; therefore, their transfer results in the current recognition of gain. The presence of tainted assets triggers gain because Congress does not want taxpayers to be able to shift the gain outside of U.S. jurisdiction. The gain recognized is ordinary or capital, depending on the nature of the asset involved.

count toward the 80 percent control requirement and Sam would still have a taxable exchange.

ASSUMPTION OF LIABILITIES—§ 357

LO.3

Understand the special rules that apply when a corporation assumes a shareholder's liability.

Without a provision to the contrary, the transfer of mortgaged property to a controlled corporation could require recognition of gain by the transferor if the corporation took over the mortgage. This would be consistent with the treatment given in like-kind exchanges under § 1031. Liabilities assumed by the other party are considered the equivalent of cash and treated as boot received. Section 357(a) provides, however, that when the acquiring corporation assumes a liability in a § 351 transaction, the liability is not treated as boot received for gain recognition purposes. Nevertheless, liabilities assumed by the transferee corporation are treated as boot in determining the basis of the stock received. As a result, the basis of the stock received is reduced by the amount of the liabilities assumed by the corporation.

EXAMPLE 11

Vera transfers property with an adjusted basis of $60,000, fair market value of $100,000, to Gray Corporation for 100% of the stock in Gray. The property is subject to a liability of $25,000 that Gray Corporation assumes. The exchange is tax-free under § 351 because the release of a liability is not treated as boot under § 357(a). However, the basis to Vera of the Gray stock is $35,000 [$60,000 (basis of property transferred) − $25,000 (amount of the liability assumed by Gray)]. ■

The general rule of § 357(a) has two exceptions: (1) § 357(b) provides that if the principal purpose of the assumption of the liabilities is to avoid tax *or* if there is no bona fide business purpose behind the exchange, the liabilities are treated as boot; and (2) § 357(c) provides that if the sum of the liabilities exceeds the adjusted basis of the properties transferred, the excess is taxable gain.

Exception (1): Tax Avoidance or No Bona Fide Business Purpose

Unless liabilities are incurred shortly before incorporation, § 357(b) generally poses few problems. A tax avoidance purpose for transferring liabilities to a controlled corporation normally is not a concern in view of the basis adjustment as noted above. Since the liabilities transferred reduce the basis of the stock received, any realized gain merely is deferred and not completely eliminated. Any postponed gain is recognized when and if the stock is disposed of in a taxable sale or exchange.

Satisfying the bona fide business purpose is not difficult if the liabilities were incurred in connection with the transferor's normal course of conducting a trade or business. But the bona fide business purpose requirement can cause difficulty if the liability is taken out shortly before the property is transferred and the proceeds are

utilized for personal purposes.[20] This type of situation is analogous to a cash distribution by the corporation, which is taxed as boot.

EXAMPLE 22

Dan transfers real estate (basis of $40,000 and fair market value of $90,000) to a controlled corporation in return for stock in the corporation. Shortly before the transfer, Dan mortgages the real estate and uses the $20,000 of proceeds to meet personal obligations. Thus, along with the real estate, the mortgage is transferred to the corporation. In this case, the assumption of the mortgage lacks a bona fide business purpose. Consequently, the release of the liability is treated as boot received, and Dan has a taxable gain on the transfer of $20,000, computed as follows:[21]

Stock	$ 70,000
Release of liability—treated as boot	20,000
Total amount realized	$ 90,000
Less: Basis of real estate	(40,000)
Realized gain	$ 50,000
Recognized gain	$ 20,000

■

The effect of the application of § 357(b) is to taint *all* liabilities transferred, even if some are supported by a bona fide business purpose.

EXAMPLE 23

Tim, an accrual basis taxpayer, incorporates his sole proprietorship. Among the liabilities transferred to the new corporation are trade accounts payable of $100,000 and a credit card bill of $5,000. Tim had used the credit card to purchase a wedding anniversary gift for his wife. Under these circumstances, the *entire* $105,000 of liabilities is boot and triggers the recognition of gain to the extent gain is realized. ■

Exception (2): Liabilities in Excess of Basis

Section 357(c) states that, if the amount of the liabilities assumed *exceeds* the total of the adjusted bases of the properties transferred, the excess is taxable gain. Without this provision, if liabilities exceed the basis in the property exchanged, a taxpayer would have a negative basis in the stock received in the controlled corporation.[22] Section 357(c) precludes the negative basis possibility by treating the excess over basis as gain to the transferor.

EXAMPLE 24

Andre transfers land and equipment with adjusted bases of $35,000 and $5,000, respectively, to a newly formed corporation in exchange for 100% of the stock. The corporation assumes $50,000 of liabilities on the transferred land. Without § 357(c), Andre's basis in the stock of the new corporation would be a negative $10,000 [$40,000 (bases of properties transferred) + $0 (gain recognized) − $0 (boot received) − $50,000 (liabilities assumed)]. Section 357(c), however, causes Andre to recognize a gain of $10,000 ($50,000 liabilities assumed − $40,000 bases of assets transferred). As a result, the stock has a zero basis in Andre's hands, determined as follows:

Bases in the properties transferred ($35,000 + $5,000)	$ 40,000
Plus: Gain recognized	10,000
Less: Boot received	(–0–)
Less: Liabilities assumed	(50,000)
Basis in the stock received	$ –0–

Thus, Andre recognizes $10,000 of gain, and a negative stock basis is avoided. ■

[20] See, for example, *Campbell, Jr. v. Wheeler*, 65–1 USTC ¶9294, 15 AFTR 2d 578, 342 F.2d 837 (CA–5, 1965).

[21] § 351(b).

[22] *Jack L. Easson*, 33 T.C. 963 (1960), *rev'd* in 61–2 USTC ¶9654, 8 AFTR 2d 5448, 294 F.2d 653 (CA–9, 1961).

The definition of liabilities under § 357(c) excludes obligations that would have been deductible to the transferor had those obligations been paid before the transfer. Thus, accounts payable of a cash basis taxpayer that give rise to a deduction are not considered to be liabilities for purposes of § 357(c). In addition, they are not considered in the computation of the shareholder's stock basis.

EXAMPLE 35

Tina, a cash basis taxpayer, incorporates her sole proprietorship. In return for all of the stock of the new corporation, she transfers the following items:

	Adjusted Basis	Fair Market Value
Cash	$10,000	$10,000
Unrealized accounts receivable (amounts due to Tina but not yet received by her)	–0–	40,000
Trade accounts payable	–0–	30,000
Note payable	5,000	5,000

Unrealized accounts receivable and trade accounts payable have a zero basis. Under the cash method of accounting, no income is recognized until the receivables are collected, and no deduction materializes until the payables are satisfied. The note payable has a basis because it was issued for consideration received.

In this situation, the trade accounts payable are disregarded for gain recognition purposes and in determining Tina's stock basis. Thus, because the balance of the note payable does not exceed the basis of the assets transferred, Tina does not have a problem of liabilities in excess of basis (i.e., the note payable of $5,000 does not exceed the aggregate basis in the cash and accounts receivable of $10,000). ■

If §§ 357(b) and (c) both apply to the same transfer, § 357(b) dominates.[23] This could be significant because § 357(b) does not create gain on the transfer, as does § 357(c), but merely converts the liability to boot. Thus, the realized gain limitation continues to apply to § 357(b) transactions.

EXAMPLE 36

Chris owns land with a basis of $100,000 and a fair market value of $1 million. The land is subject to a mortgage of $300,000. One month prior to transferring the land to Robin Corporation, Chris borrows an additional $200,000 for personal purposes and gives the lender a second mortgage on the land. Therefore, upon the incorporation, Robin Corporation issues stock worth $500,000 to Chris and assumes the mortgages on the land.

Both § 357(c) and § 357(b) apply to the transfer. The mortgages on the property ($500,000) exceed the basis of the property ($100,000). Thus, Chris has a gain of $400,000 under § 357(c). Chris borrowed $200,000 just prior to the transfer and used the loan proceeds for personal purposes. Under § 357(b), Chris has boot of $500,000 in the amount of the liabilities. Note that *all* of the liabilities are treated as boot, not just the "tainted" $200,000 liability. He has realized gain of $900,000 [$1,000,000 (stock of $500,000 and assumption of liabilities of $500,000) – $100,000 (basis in the land)]. Gain is recognized to the extent of the boot received of $500,000. Section 357(b) dominates over § 357(c). ■

[23] § 357(c)(2)(A).

Tax Planning Strategies — Avoiding § 351

FRAMEWORK FOCUS: TAX RATE

Strategy: Shift Net Income from High-Bracket Years to Low-Bracket Years. Control the Character of Income and Deductions.

Section 351(a) provides for the nonrecognition of gain on transfers to controlled corporations. As such, it is often regarded as a relief provision favoring taxpayers. In some situations, however, avoiding § 351(a) may produce a more advantageous tax result. The transferors might prefer to recognize gain on the transfer of property if the tax cost is low. For example, they may be in low tax brackets, or the gain may be a capital gain from which substantial capital losses can be offset. Also, recognition of gain will lead to a stepped-up basis in the transferred property in the corporation.

Another reason a particular transferor might wish to avoid § 351 concerns possible loss recognition. Recall that § 351 refers to the nonrecognition of both gains and losses. Section 351(b)(2) specifically states: "No loss to such recipient shall be recognized." A transferor who wishes to recognize loss has several alternatives:

- Sell the property to the corporation for its stock. The IRS could attempt to collapse the "sale," however, by taking the approach that the transfer really falls under § 351(a).[24]
- Sell the property to the corporation for other property or boot. Because the transferor receives no stock, § 351 is inapplicable.
- Transfer the property to the corporation in return for securities or nonqualified preferred stock. Recall that § 351 does not apply to a transferor who receives securities or nonqualified preferred stock. In both this and the previous alternatives, watch for the possible disallowance of the loss under the related-party rules.

Suppose loss property is to be transferred to the corporation and no loss is recognized by the transferor due to § 351(a). This could present an interesting problem in terms of assessing the economic realities involved.

EXAMPLE 21

Iris and Ivan form Wren Corporation with the following investments: property by Iris (basis of $40,000 and fair market value of $50,000) and property by Ivan (basis of $60,000 and fair market value of $50,000). Each receives 50% of the Wren stock. Has Ivan acted wisely in settling for only 50% of the stock? At first, it would appear so, since Iris and Ivan each invested property of the same value ($50,000). But what about tax considerations? By applying the general carryover basis rules, the corporation now has a basis of $40,000 in Iris's property and $60,000 in Ivan's property. In essence, Iris has shifted a possible $10,000 gain to the corporation while Ivan has transferred a $10,000 potential loss. With this in mind, an equitable allocation of the Wren stock would call for Ivan to receive a greater percentage interest than Iris.

This issue is further complicated by the special basis adjustment required when a shareholder, such as Ivan, contributes property with a built-in loss to a corporation. (See the discussion of this basis adjustment for loss property in the next section.) In this situation, if Wren is to take a carryover basis in Ivan's property, Ivan must reduce his stock basis by the $10,000 built-in loss. This reduced stock basis, of course, could lead to a greater tax burden on Ivan when he sells the Wren stock. This may suggest additional support for Ivan having a greater percentage interest than Iris. ■

LO.4

Recognize the basis issues relevant to the shareholder and the corporation.

BASIS DETERMINATION AND OTHER ISSUES

Recall that § 351(a) postpones gain or loss recognition until the taxpayer's investment changes substantively. By virtue of the basis rules described below, the postponed gain or loss is recognized when the stock is disposed of in a taxable transaction.

Basis of Stock to Shareholder

For a taxpayer transferring property to a corporation in a § 351 transaction, the basis of *stock* received in the transaction is the same as the basis the taxpayer had in the property transferred, increased by any gain recognized on the exchange of property and decreased by boot received. For basis purposes, boot received includes liabilities transferred by the shareholder to the corporation. Also note that if the shareholder receives *other property* (i.e., boot) along with the stock, it takes a basis equal to its fair market

[24] *U.S. v. Hertwig*, 68–2 USTC ¶9495, 22 AFTR 2d 5249, 398 F.2d 452 (CA–5, 1968).

FIGURE 9.1 Shareholder's Basis of Stock Received in Exchange for Property

Adjusted basis of property transferred	$xx,xxx
Plus: Gain recognized	xxx
Minus: Boot received (including any liabilities transferred)	(xxx)
Minus: Adjustment for loss property (if elected)	(xxx)
Equals: Basis of stock received	$xx,xxx

value.[25] In Figure 9.1, the reference to gain recognized does not consider any income resulting from the performance of personal services. (Recall from earlier discussions that the basis of stock received for services equals its fair market value.) See the discussion that follows relating to an elective stock basis reduction that may be taken when a shareholder contributes property with a net built-in loss.

Basis of Property to Corporation

The basis of property received by the corporation generally is the basis of the exchanged property in the hands of the transferor increased by the amount of any gain recognized on the transfer by the transferor-shareholder.[26]

These basis rules are illustrated in Examples 28 and 29.

EXAMPLE 28

Maria and Ned form Brown Corporation. Maria transfers land (basis of $30,000 and fair market value of $70,000); Ned invests cash ($60,000). They each receive 50 shares in Brown Corporation, worth $1,200 per share, but Maria also receives $10,000 cash from Brown. The transfers of property, the realized and recognized gain on the transfers, and the basis of the stock in Brown Corporation to Maria and Ned are as follows:

	A	B	C	D	E	F
	Basis of Property Transferred	FMV of Stock Received	Boot Received	Realized Gain (B + C − A)	Recognized Gain (Lesser of C or D)	Basis of Stock in Brown (A − C + E)
From Maria:						
Land	$30,000	$60,000	$10,000	$40,000	$10,000	$30,000
From Ned:						
Cash	60,000	60,000	–0–	–0–	–0–	60,000

Brown Corporation has a basis of $40,000 in the land (Maria's basis of $30,000 plus her recognized gain of $10,000). ■

EXAMPLE 29

Assume the same facts as in Example 28 except that Maria's basis in the land is $68,000 (instead of $30,000). Because recognized gain cannot exceed realized gain, the transfer generates only $2,000 of gain to Maria. The realized and recognized gain and the basis of the stock in Brown Corporation to Maria are as follows:

	A	B	C	D	E	F
	Basis of Property Transferred	FMV of Stock Received	Boot Received	Realized Gain (B + C − A)	Recognized Gain (Lesser of C or D)	Basis of Stock in Brown (A − C + E)
Land	$68,000	$60,000	$10,000	$2,000	$2,000	$60,000

Brown's basis in the land is $70,000 ($68,000 basis to Maria + $2,000 gain recognized by Maria). ■

[25] § 358(a).

[26] § 362(a).



CONCEPT SUMMARY 9.1

Tax Consequences to the Shareholders and Corporation: With and Without the Application of § 351 (Based on the Facts of Example 28)

	With § 351			Without § 351		
Shareholder	**Gain/Loss Recognized**	**Stock Basis**	**Other Property Basis**	**Gain/Loss Recognized**	**Stock Basis**	**Other Property Basis**
Maria	Realized gain recognized to extent of boot received; loss not recognized.	Substituted (see Figure 9.1).	FMV	All realized gain or loss recognized.	FMV	FMV
	$10,000	$30,000	$10,000	$40,000	$60,000	$10,000

	With § 351		Without § 351	
Corporation	**Gain/Loss Recognized**	**Property Basis**	**Gain/Loss Recognized**	**Property Basis**
Brown	No gain or loss recognized on the transfer of corporate stock for property.	Carryover (see Figure 9.2).	No gain or loss recognized on the transfer of corporate stock for property.	FMV
	$0	$40,000	$0	$70,000

Note that the benefit to Maria of deferring $30,000 of gain under § 351 comes with a cost: her stock basis is $30,000 (rather than $60,000), and the corporation's basis in the property received is $40,000 (rather than $70,000).

Figure 9.2 summarizes the basis calculation for property received by a corporation. Concept Summary 9.1 shows the shareholder and corporate consequences of a transfer of property to a corporation for stock, with and without the application of § 351. The facts applicable to shareholder Maria's transfer in Example 28 are used to illustrate the differences between the transaction being tax deferred and taxable.

Basis Adjustment for Loss Property

As noted above, when a corporation receives property in a § 351 transaction, the basis for that property is carried over from the shareholder. As a result, the corporation's basis for the property has no correlation to its fair market value. However, in certain situations when **built-in loss property** is contributed to a corporation, its

FIGURE 9.2 Corporation's Basis in Property Received

Adjusted basis of property transferred	$xx,xxx
Plus: Gain recognized by transferor-shareholder	xxx
Minus: Adjustment for loss property (if required)	(xxx)
Equals: Basis of property to corporation	$xx,xxx

aggregate basis in the property may have to be stepped down so that the basis does not exceed the fair market value of the property transferred. This basis adjustment is necessary to prevent the parties from obtaining a double benefit from the losses involved.

The anti-loss duplication rule applies when the aggregate basis of the assets transferred by a shareholder exceeds their fair market value. When this built-in loss situation exists, the basis in the loss properties is stepped down. The step-down in basis is allocated proportionately among the assets with the built-in loss.[27]

In a transaction qualifying under § 351, Charles transfers the following assets to Gold Corporation in exchange for all of its stock:

	Tax Basis	Fair Market Value	Built-In Gain/ (Loss)
Equipment	$100,000	$ 90,000	($10,000)
Land	200,000	230,000	30,000
Building	150,000	100,000	(50,000)
	$450,000	$420,000	($30,000)

Charles's stock basis is $450,000 [$450,000 (basis of the property transferred) + $0 (gain recognized) − $0 (boot received)]. However, Gold's basis for the loss assets transferred must be reduced by the amount of the net built-in loss ($30,000) in proportion to each asset's share of the loss.

	Unadjusted Tax Basis	Adjustment	Adjusted Tax Basis
Equipment	$100,000	($ 5,000)*	$ 95,000
Land	200,000		200,000
Building	150,000	(25,000)**	125,000
	$450,000	($30,000)	$420,000

* $\frac{\$10{,}000 \text{ (loss attributable to equipment)}}{\$60{,}000 \text{ (}\textit{total}\text{ built-in loss)}} \times \$30{,}000 \text{ (}\textit{net}\text{ built-in loss)}$
= $5,000 (adjustment to basis in equipment).

** $\frac{\$50{,}000 \text{ (loss attributable to building)}}{\$60{,}000 \text{ (}\textit{total}\text{ built-in loss)}} \times \$30{,}000 \text{ (}\textit{net}\text{ built-in loss)}$
= $25,000 (adjustment to basis in building). ■

Note the end result of Example 30:

- Charles still has a built-in loss in his stock basis. Thus, if he sells the Gold Corporation stock, he will recognize a loss of $30,000 [$420,000 (selling price based on presumed value of the stock) − $450,000 (basis in the stock)].
- Gold Corporation can no longer recognize any loss on the sale of *all* of its assets [$420,000 (selling price based on value of assets) − $420,000 (adjusted basis in assets) = $0 (gain or loss)].

In the event a corporation is subject to the built-in loss adjustment, an alternative approach is available. If the shareholder and the corporation both elect, the basis reduction can be made to the shareholder's stock rather than to the corporation's property.

[27] § 362(e)(2). This adjustment is determined separately with respect to each property transferor. In addition, this adjustment also is required in the case of a contribution to capital by a shareholder.

EXAMPLE 32

Assume the same facts as in the previous example. If Charles and Gold elect, Charles can reduce his stock basis to $420,000 ($450,000 − $30,000). As a result, Gold's aggregate basis in the assets it receives is $450,000. If Charles has no intention of selling his stock, this election could be desirable as it benefits Gold by giving the corporation a higher depreciable basis in the equipment and building. ■

Note the end result of Example 31:

- Charles has no built-in loss. Thus, if he sells the Gold Corporation stock, he will recognize no gain or loss [$420,000 (presumed value of the stock) − $420,000 (basis in the stock)].
- Gold Corporation has a built-in loss. Thus, if it sells *all* of its assets [$420,000 (selling price based on value of assets) − $450,000 (basis in assets)], it recognizes a loss of $30,000.

Consequently, the built-in loss adjustment places the loss with either the shareholder or the corporation but not both (compare Examples 30 and 31).

Stock Issued for Services Rendered

A corporation's transfer of stock for property is not a taxable exchange.[28] A transfer of shares for services is also not a taxable transaction to a corporation.[29] Can a corporation deduct the fair market value of the stock it issues in consideration of services as a business expense? Yes, unless the services are such that the payment is characterized as a capital expenditure.[30]

EXAMPLE 33

Carol and Carl form White Corporation. Carol transfers cash of $500,000 for 100 shares of White Corporation stock. Carl transfers property worth $400,000 (basis of $90,000) and agrees to serve as manager of the corporation for one year; in return, Carl receives 100 shares of stock in White. The value of Carl's services to White Corporation is $100,000. Carol's and Carl's transfers qualify under § 351. Neither Carol nor Carl is taxed on the transfer of their property. However, Carl has income of $100,000, the value of the services he will render to White Corporation. White has a basis of $90,000 in the property it acquired from Carl, and it may claim a compensation expense deduction under § 162 for $100,000. Carl's stock basis is $190,000 [$90,000 (basis of property transferred) + $100,000 (income recognized for services rendered)]. ■

EXAMPLE 34

Assume, in the preceding example, that Carl receives the 100 shares of White Corporation stock as consideration for the appreciated property and for providing legal services in organizing the corporation. The value of Carl's legal services is $100,000. Carl has no gain on the transfer of the property but has income of $100,000 for the value of the services rendered. White Corporation has a basis of $90,000 in the property it acquired from Carl and must capitalize the $100,000 as an organizational expenditure. Carl's stock basis is $190,000 [$90,000 (basis of property transferred) + $100,000 (income recognized for services rendered)]. ■

Holding Period for Shareholder and Transferee Corporation

The shareholder's holding period for stock received for a capital asset or for § 1231 property includes the holding period of the property transferred to the corporation. The holding period of the property is *tacked on* to the holding period of the stock. The holding period for stock received for any other property (e.g., inventory) begins on the day after the exchange. The transferee corporation's holding period

[28] § 1032.
[29] Reg. § 1.1032–1(a).
[30] Rev.Rul. 62–217, 1962–2 C.B. 59, modified by Rev.Rul. 74–503, 1974–2 C.B. 117.

for property acquired in a § 351 transfer is the holding period of the transferor-shareholder regardless of the character of the property to the transferor.[31]

RECAPTURE CONSIDERATIONS

In a § 351(a) nontaxable transfer (no boot involved) to a controlled corporation, the depreciation recapture rules do not apply.[32] Instead, any recapture potential of the property carries over to the corporation as it steps into the shoes of the transferor-shareholder for purposes of basis determination. However, to the extent that gain is recognized, the recapture rules are applied.

EXAMPLE 34

Paul transfers equipment (adjusted basis of $30,000, original cost of $120,000, and fair market value of $100,000) to a controlled corporation in return for additional stock. If Paul had sold the equipment, it would have yielded a gain of $70,000, all of which would be recaptured as ordinary income under § 1245. If the transfer comes within § 351(a), Paul has no recognized gain and no depreciation to recapture. If the corporation later disposes of the equipment in a taxable transaction, it must take into account the § 1245 recapture potential originating with Paul.

If Paul had received boot of $60,000 on the transfer, all of the recognized gain would be recaptured as ordinary income. The remaining $10,000 of recapture potential would carry over to the corporation. ■

Tax Planning Strategies OTHER CONSIDERATIONS WHEN INCORPORATING A BUSINESS

FRAMEWORK FOCUS: TAX RATE

Strategy: Control the Character of Income and Deductions.
Shift Net Income from High-Bracket Taxpayers to Low-Bracket Taxpayers.

FRAMEWORK FOCUS: DEDUCTIONS

Strategy: Maximize Deductible Amounts.

FRAMEWORK FOCUS: INCOME AND EXCLUSIONS

Strategy: Avoid Income Recognition.

When a business is incorporated, the organizers must determine which assets and liabilities should be transferred to the corporation. A transfer of assets that produce passive income (rents, royalties, dividends, and interest) can cause the corporation to be a personal holding company in a tax year when operating income is low. Thus, the corporation could be subject to the personal holding company penalty tax (see the discussion in Chapter 10).

A transfer of the accounts payable of a cash basis taxpayer may prevent the taxpayer from taking a tax deduction when the accounts are paid. These payables should generally be retained.

Leasing property to the corporation may be a more attractive alternative than transferring ownership. Leasing provides the taxpayer with the opportunity of withdrawing money from the corporation in a deductible form without the payment being characterized as a nondeductible dividend. If the property is donated to a family member in a lower tax bracket, the lease income can be shifted as well. If the depreciation and other deductions available in connection with the property are larger than the lease income, a high tax rate taxpayer could retain the property until the income exceeds the deductions.

Another way to shift income to other taxpayers is by the use of corporate debt. Shareholder debt in a corporation can be given to family members with low marginal tax rates. This technique also shifts income without a loss of control of the corporation.

[31] §§ 1223(1) and (2).

[32] §§ 1245(b)(3) and 1250(d)(3).

TAX in the News

Government-Provided Economic Incentives Can Flow on a Two-Way Street

Corporations often obtain grants from state and local governments as incentives to expand their business. Jurisdictions that provide these incentives do so with the expectation that additional tax revenues (e.g., income tax, property tax, sales tax) will result. These types of economic development grants do not generate taxable income to the corporation.

Expansion projects do not always go according to plan, however. In one such deal, Philip Morris USA received a grant from the city of Concord and Cabarrus County in North Carolina to make equipment upgrades. When Philip Morris decided to move some of its production capacity to Europe, it no longer needed the equipment upgrades. As a result, Philip Morris agreed to return to Concord and Cabarrus County $313,000 of tax incentives it had received as a part of the grant. What is the likely tax effect to Philip Morris of the repayment? Since the company was not required to report income on the receipt of the grant, it should not obtain a deduction on its repayment.

9.3 Capital Structure of a Corporation

LO.5

Understand the tax aspects of the capital structure of a corporation.

CAPITAL CONTRIBUTIONS

When a corporation receives money or property in exchange for capital stock (including treasury stock), neither gain nor loss is recognized by the recipient corporation.[33] The corporation's gross income also does not include shareholders' contributions of money or property to the capital of the corporation. Additional funds received from shareholders through voluntary pro-rata payments are not income to the corporation. This is the case even though there is no increase in the number of outstanding shares of stock of the corporation. The payments represent an additional price paid for the shares held by the shareholders (increasing their basis) and are treated as additions to the operating capital of the corporation.[34]

Contributions by nonshareholders, such as land contributed to a corporation by a civic group or a governmental group to induce the corporation to locate in a particular community, are also excluded from the gross income of a corporation.[35] However, property that is transferred to a corporation by a nonshareholder in exchange for goods or services rendered is taxable income to the corporation.[36]

EXAMPLE 11

A cable company charges its customers an initial fee to hook up to a new cable system installed in the area. These payments are used to finance the total cost of constructing the cable facilities. The customers will make monthly payments for the cable service. The initial payments are used for capital expenditures, but they represent payments for services to be rendered by the cable company. As such, they are taxable income and not contributions to capital by nonshareholders. ■

The basis of property received by a corporation from a shareholder as a **capital contribution** is equal to the basis of the property in the hands of the shareholder, although the basis may be subject to a downward adjustment when loss property is contributed. The basis of property transferred to a corporation by a nonshareholder as a contribution to capital is zero.

[33] § 1032.

[34] § 118 and Reg. § 1.118–1.

[35] See *Edwards v. Cuba Railroad Co.*, 1 USTC ¶139, 5 AFTR 5398, 45 S.Ct. 614 (USSC, 1925).

[36] Reg. § 1.118–1. See also *Teleservice Co. of Wyoming Valley*, 27 T.C. 722 (1957), *aff'd* in 58–1 USTC ¶9383, 1 AFTR 2d 1249, 254 F.2d 105 (CA–3, 1958), *cert. den.* 78 S.Ct. 1360 (USSC, 1958).

TAX in the News

Debt That Cannot Be Fully Repaid

Having debt in the capital structure of a corporation can carry many tax advantages to the parties involved. Problems arise, however, when such debt becomes due and cannot be fully repaid by the corporate debtor. In the case of outside creditors (i.e., nonshareholders), the options are twofold: declare bankruptcy or restructure the terms of the debt. The last option entails reducing the amount of the debt or allowing the debtor to repurchase the debt instruments (e.g., notes, bonds) at a discount. Either way generates income to the debtor under the discharge of indebtedness provision of § 108. Because the results are less drastic to the parties involved (i.e., creditor/debtor) and less disruptive in economic effect, Congress has attempted to encourage the use of the restructuring option.

Under the American Recovery and Reinvestment Tax Act of 2009, the income from the repurchase of business debt at a discount can be deferred until 2014 and can be spread over the next five years. The new income deferral rules apply to repurchase situations occurring after December 31, 2008, and before January 1, 2011. The new "buyback" rules will be of particular benefit in helping many private equity firms avoid bankruptcy due to their troubled debt.

If a corporation receives *money* as a contribution to capital from a nonshareholder, a special rule applies. The basis of any property acquired with the money during a 12-month period beginning on the day the contribution was received is reduced by the amount of the contribution. The excess of money received over the cost of new property is used to reduce the basis of other property held by the corporation and is applied in the following order:

- Depreciable property.
- Property subject to amortization.
- Property subject to depletion.
- All other remaining properties.

The basis of property within each category is reduced in proportion to the relative bases of the properties.[37]

EXAMPLE 10

A city donates land to Brown Corporation as an inducement for Brown to locate in the city. The receipt of the land produces no taxable income to Brown, and the land's basis to the corporation is zero. If, in addition, the city gives the corporation $100,000 in cash, the money is not taxable income to the corporation. However, if the corporation purchases property with the $100,000 within the next 12 months, the basis of the property is reduced by $100,000. Any excess cash not used is handled according to the ordering rules noted above. ■

DEBT IN THE CAPITAL STRUCTURE

LO.6

Recognize the tax differences between debt and equity investments.

Advantages of Debt

Significant tax differences exist between debt and equity in the capital structure, and shareholders must be aware of these differences. The advantages of issuing long-term debt are numerous. Interest on debt is deductible by the corporation, while dividend payments are not. Further, the shareholders are not taxed on debt repayments unless the repayments exceed basis. An investment in stock usually cannot be withdrawn tax-free as long as a corporation has earnings and profits. Withdrawals will be deemed to be taxable dividends to the extent of earnings and profits of the distributing corporation. (The concept of earnings and profits is discussed in Chapter 10.)

[37] § 362(c); Reg. §§ 1.362–2(b) and 1.118–1.

Currently, another distinction between debt and equity relates to the taxation of dividend and interest income. Dividend income on equity holdings is taxed to individual investors at the low capital gains rates, while interest income on debt is taxed at the higher ordinary income rates.

EXAMPLE 37

Wade transfers cash of $100,000 to a newly formed corporation for 100% of the stock. In the first year of operations, the corporation has net income of $40,000. If the corporation distributes $9,500 to Wade, the distribution is a taxable dividend with no corresponding deduction to the corporation. Assume, instead, that Wade transfers to the corporation cash of $50,000 for stock. In addition, he lends the corporation $50,000. The note is payable in equal annual installments of $5,000 and bears interest at the rate of 9%. At the end of the year, the corporation pays Wade interest of $4,500 ($50,000 × 9%), and a note repayment of $5,000. The interest payment is taxable to Wade and deductible to the corporation. The $5,000 principal repayment on the loan is neither taxed to Wade nor deductible by the corporation. The after-tax impact to Wade and the corporation under each alternative is illustrated below.

	If the Distribution Is	
	$9,500 Dividend	$5,000 Note Repayment and $4,500 Interest
*After-tax benefit to Wade**		
[$9,500 × (1 − 15%)]	$8,075	
{$5,000 + [$4,500 × (1 − 35%)]}		$7,925
*After-tax cost to corporation***		
No deduction to corporation	$9,500	
{$5,000 + [$4,500 × (1 − 35%)]}		$7,925

*Assumes Wade's dividend income is taxed at the 15% capital gains rate and his interest income is taxed at the 35% ordinary income rate.
**Assumes the corporation is in the 35% marginal tax bracket. ■

Reclassification of Debt as Equity (Thin Capitalization Problem)

In situations where the corporation is said to be thinly capitalized, the IRS contends that debt is really an equity interest and denies the corporation the tax advantages of debt financing. If a debt instrument has too many features of stock, it may be treated as a form of stock by the IRS. As a result, the principal and interest payments are considered dividends. Under § 385, the IRS has the authority to characterize corporate debt wholly as equity or as part debt and part equity. In the current environment, however, the IRS may be less inclined to raise the thin capitalization issue because the conversion of interest income to dividend income would produce a tax benefit to individual investors.

For the most part, the principles used to classify debt as equity developed in connection with closely held corporations where the holders of the debt are often shareholders. The rules have often proved inadequate for dealing with large, publicly traded corporations.

Section 385 lists several factors that *may* be used to determine whether a debtor-creditor relationship or a shareholder-corporation relationship exists. The thrust of § 385 is to authorize the Treasury to prescribe Regulations that provide more definite guidelines for determining when debt should be reclassified as equity. To date, the Treasury Department has not drafted final Regulations. Consequently, taxpayers must rely on judicial decisions to determine whether a true debtor-creditor relationship exists.

The courts have identified the following factors to be considered when classifying a security as debt or equity:

- Whether the debt instrument is in proper form. An open account advance is more easily characterized as a contribution to capital than a loan evidenced by a properly written note executed by the shareholder.[38]
- Whether the debt instrument bears a reasonable rate of interest and has a definite maturity date. When a shareholder advance does not provide for interest, the return expected is that inherent in an equity interest (e.g., a share of the profits or an increase in the value of the shares).[39] Likewise, a lender unrelated to the corporation will usually be unwilling to commit funds to the corporation for an indefinite period of time (i.e., no definite due date).
- Whether the debt is paid on a timely basis. A lender's failure to insist upon timely repayment (or satisfactory renegotiation) indicates that the return sought does not depend upon interest income and the repayment of principal.
- Whether payment is contingent upon earnings. A lender ordinarily will not advance funds that are likely to be repaid only if the venture is successful.
- Whether the debt is subordinated to other liabilities. Subordination tends to eliminate a significant characteristic of the creditor-debtor relationship. Creditors should have the right to share with other general creditors in the event of the corporation's dissolution or liquidation. Subordination also destroys another basic attribute of creditor status—the power to demand payment at a fixed maturity date.[40]
- Whether holdings of debt and stock are proportionate (e.g., each shareholder owns the same percentages of debt and stock). When debt and equity obligations are held in the same proportion, shareholders are, apart from tax considerations, indifferent as to whether corporate distributions are in the form of interest or dividends.
- Whether funds loaned to the corporation are used to finance initial operations or capital asset acquisitions. Funds used to finance initial operations or to acquire capital assets the corporation needs to operate are generally obtained through equity investments.
- Whether the corporation has a high ratio of shareholder debt to shareholder equity. **Thin capitalization** occurs when shareholder debt is high relative to shareholder equity. This indicates the corporation lacks reserves to pay interest and principal on debt when corporate income is insufficient to meet current needs.[41] In determining a corporation's debt-equity ratio, courts look at the relation of the debt both to the book value of the corporation's assets and to their actual fair market value.[42]

Section 385 also authorizes the Treasury to issue Regulations classifying an instrument either as *wholly* debt or equity or as *part* debt and *part* equity. This flexible approach is important because some instruments cannot readily be classified either wholly as stock or wholly as debt. It may also provide an avenue for the IRS to address problems in publicly traded corporations.

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[38] *Estate of Mixon, Jr. v. U.S.*, 72–2 USTC ¶9537, 30 AFTR 2d 72–5094, 464 F.2d 394 (CA–5, 1972).

[39] *Slappey Drive Industrial Park v. U.S.*, 77–2 USTC ¶9696, 40 AFTR 2d 77–5940, 561 F.2d 572 (CA–5, 1977).

[40] *Fin Hay Realty Co. v. U.S.*, 68–2 USTC ¶9438, 22 AFTR 2d 5004, 398 F.2d 694 (CA–3, 1968).

[41] A court held that a debt-equity ratio of approximately 14.6:1 was not excessive. See *Tomlinson v. 1661 Corp.*, 67–1 USTC ¶9438, 19 AFTR 2d 1413, 377 F.2d 291 (CA–5, 1967). A 26:1 ratio was found acceptable in *Delta Plastics, Inc.*, 85 TCM 940, T.C.Memo. 2003–54.

[42] In *Bauer v. Comm.*, 84–2 USTC ¶9996, 55 AFTR 2d 85–433, 748 F.2d 1365 (CA–9, 1984), a debt-equity ratio of 92:1 resulted when book value was used. But the ratio ranged from 2:1 to 8:1 when equity included both paid-in capital and accumulated earnings.

9.4 Corporate Operations

LO.7
Understand the tax rules unique to corporations.

The rules related to gross income, deductions, and losses discussed in previous chapters of this text generally apply to corporations. In a few instances, it was noted that corporations face unique limitations such as the 10 percent of taxable income limitation for charitable contributions and the limitation allowing corporate capital losses to be deductible only against capital gains. Corporations also are permitted some deductions not generally available to other entities. These special deductions and other special rules regarding the determination of the corporate income tax liability are discussed in the following pages.

DEDUCTIONS AVAILABLE ONLY TO CORPORATIONS

Dividends Received Deduction

The purpose of the **dividends received deduction** is to mitigate multiple taxation of corporate income. Without the deduction, dividends paid between corporations could be subject to several levels of tax. For example, if Corporation A pays Corporation B a dividend, and B passes the dividend on to its shareholders, the dividend is taxed at three levels: Corporation A, Corporation B, and Corporation B's shareholders. The dividends received deduction alleviates this inequity by limiting or eliminating the amount of dividend income taxable to corporations.

As the following table illustrates, the amount of the dividends received deduction depends on the percentage of ownership (voting power and value) the recipient corporate shareholder holds in a *domestic corporation* making the dividend distribution.[43]

Percentage of Ownership by Corporate Shareholder	Deduction Percentage
Less than 20%	70%
20% or more (but less than 80%)	80%
80% or more*	100%

*The payor corporation must be a member of an affiliated group with the recipient corporation.

The dividends received deduction is limited to a percentage of the taxable income of the shareholder-corporation. For this purpose, taxable income is computed without regard to the net operating loss (NOL) deduction, the domestic production activities deduction, the dividends received deduction, and any capital loss carryback to the current tax year. The percentage of taxable income limitation corresponds to the deduction percentage. Thus, if a corporate shareholder owns less than 20 percent of the stock in the distributing corporation, the dividends received deduction is limited to 70 percent of taxable income. However, the taxable income limitation does not apply if the corporation has an NOL for the current taxable year.[44]

The following steps are useful in the computation of the deduction:

1. Multiply the dividends received by the deduction percentage.
2. Multiply the taxable income by the deduction percentage.
3. The deduction is limited to the lesser of Step 1 or Step 2, unless deducting the amount derived in Step 1 results in an NOL. If so, the amount derived in Step 1 should be used. This is referred to as the *NOL rule.*

[43] § 243(a). Dividends from foreign corporations generally do not qualify for a dividends received deduction. But see § 245.

[44] Further, the limitation does not apply in the case of the 100% deduction available to members of an affiliated group. § 246(b)(2).

Red, White, and Blue Corporations, three unrelated calendar year corporations, report the following information for the year:

	Red Corporation	White Corporation	Blue Corporation
Gross income from operations	$ 400,000	$ 320,000	$ 260,000
Expenses from operations	(340,000)	(340,000)	(340,000)
Dividends received from domestic corporations (less than 20% ownership)	200,000	200,000	200,000
Taxable income before the dividends received deduction	$ 260,000	$ 180,000	$ 120,000

In determining the dividends received deduction, use the three-step procedure described above:

Step 1 (70% × $200,000)	$140,000	$140,000	$140,000
Step 2			
70% × $260,000 (taxable income)	$182,000		
70% × $180,000 (taxable income)		$126,000	
70% × $120,000 (taxable income)			$ 84,000
Step 3			
Lesser of Step 1 or Step 2	$140,000	$126,000	
Step 1 amount results in an NOL			$140,000

White Corporation is subject to the 70% of taxable income limitation. It does not qualify for NOL rule treatment since subtracting $140,000 (Step 1) from $180,000 (taxable income before the dividends received deduction) does not yield a negative figure. Blue Corporation qualifies under the NOL rule because subtracting $140,000 (Step 1) from $120,000 (taxable income before the dividends received deduction) yields a negative figure. In summary, each corporation has a dividends received deduction for the year as follows: $140,000 for Red Corporation, $126,000 for White Corporation, and $140,000 for Blue Corporation. ■

No dividends received deduction is allowed unless the corporation has held the stock for more than 45 days.[45] This restriction was enacted to close a tax loophole involving dividends on stock that is held only transitorily. When stock is purchased shortly before a dividend record date and soon thereafter sold ex-dividend, a capital loss corresponding to the amount of the dividend often results (ignoring other market valuation changes). If the dividends received deduction was allowed in such cases, the capital loss resulting from the stock sale would exceed the related dividend income.

On October 1, 2010, Pink Corporation (5 million shares outstanding) declares a $1 per share dividend for shareholders of record as of November 1, 2010, and payable on December 1, 2010. Black Corporation purchases 10,000 shares of Pink stock on October 28, 2010, for $25,000, and sells those 10,000 shares ex-dividend on November 5, 2010, for $15,000. (It is assumed that there is no fluctuation in the market price of the Pink stock other than the dividend element.) The sale results in a short-term capital loss of $10,000 ($15,000 amount realized − $25,000 basis). On December 1, Black receives a $10,000 dividend from Pink. Without the holding period restriction, Black Corporation would recognize a $10,000 deduction (subject to the capital loss limitation) but only $3,000 of income [$10,000 dividend − $7,000 dividends received deduction ($10,000 × 70%)], or a $7,000 net loss. However, since Black did not hold the Pink stock for more than 45 days, no dividends received deduction is allowed. ■

[45] The stock must be held more than 45 days during the 91-day period beginning on the date that is 45 days before the ex-dividend date (or, in the case of preferred stock, more than 90 days during the 181-day period beginning on the date that is 90 days before the ex-dividend date). § 246(c).



In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

Organizational Expenditures Deduction

Expenses incurred in connection with the organization of a corporation normally are chargeable to a capital account. That they benefit the corporation during its existence seems clear. But over what period should organizational expenses be amortized? The lack of a determinable and limited estimated useful life makes such a determination difficult. Section 248 was enacted to solve this problem.

Under § 248, a corporation may elect to amortize **organizational expenditures** over the 180-month period beginning with the month in which the corporation begins business.[46] Organizational expenditures include:

- Legal services incident to organization (e.g., drafting the corporate charter, bylaws, minutes of organizational meetings, terms of original stock certificates).
- Necessary accounting services.
- Expenses of temporary directors and of organizational meetings of directors or shareholders.
- Fees paid to the state of incorporation.

Expenditures that *do not qualify* as organizational expenditures include those connected with issuing or selling shares of stock or other securities (e.g., commissions, professional fees, and printing costs) or with the transfer of assets to a corporation. These expenditures reduce the amount of capital raised and are not deductible.

The first $5,000 of organizational costs can be immediately expensed, with any remaining amount of organizational costs amortized over a 180-month period. However, this $5,000 expensing amount is phased out on a dollar-for-dollar basis when these costs exceed $50,000. For example, a corporation with $52,000 of organizational costs would expense $3,000 [$5,000 − ($52,000 − $50,000)] of this amount and amortize the $49,000 balance ($52,000 − $3,000) over 180 months.

To qualify for the election, the expenditure must be *incurred* before the end of the tax year in which the corporation begins business. In this regard, the corporation's method of accounting is of no consequence. Thus, an expense incurred by a cash basis corporation in its first tax year qualifies even though the expense is not paid until a subsequent year.

A corporation is deemed to have made the election to amortize organizational expenditures for the taxable year in which it begins business. No separate statement or specific identification of the deducted amount as organizational expenditures is required. A corporation can elect to forgo the deemed election by clearly electing to capitalize organizational expenditures on a timely filed return for its first taxable year. In that case, the capitalized amount will be deductible by the corporation at such time as it ceases to do business and liquidates.

EXAMPLE 40

Black Corporation, an accrual basis, calendar year taxpayer, was formed and began operations on April 1, 2010. The following expenses were incurred during its first year of operations (April 1–December 31, 2010):

Expenses of temporary directors and of organizational meetings	$15,500
Fee paid to the state of incorporation	2,000
Accounting services incident to organization	18,000
Legal services for drafting the corporate charter and bylaws	32,000
Expenses incident to the printing and sale of stock certificates	48,000

[46]The month in which a corporation begins business may not be immediately apparent. Ordinarily, a corporation begins business when it starts the business operations for which it was organized. Reg. § 1.248–1T(d). For a similar problem in the Subchapter S area, see Chapter 12.

Black Corporation elects to amortize organizational costs under § 248. Because of the dollar cap (i.e., dollar-for-dollar reduction for amounts in excess of $50,000), no immediate expensing under the $5,000 rule is available. The monthly amortization is $375 [($15,500 + $2,000 + $18,000 + $32,000) ÷ 180 months], and $3,375 ($375 × 9 months) is deductible for tax year 2010. Note that the $48,000 of expenses incident to the printing and sale of stock certificates does not qualify for the election. These expenses cannot be deducted. Instead, they reduce the amount of the capital realized from the sale of stock. ■

Organizational expenditures are distinguished from *startup expenditures.*[47] Startup expenditures include various investigation expenses involved in entering a new business, whether incurred by a corporate or an individual taxpayer. Startup expenses also include operating expenses, such as rent and payroll, that are incurred by a corporation before it actually begins to produce any gross income. At the election of the taxpayer, such expenditures (e.g., travel, market surveys, financial audits, legal fees) are deductible in the same manner as organizational expenditures. Thus, up to $5,000 can be immediately expensed (subject to the phaseout) and any remaining amounts amortized over a period of 180 months. The same rules that apply to the deemed election (and election to forgo the deemed election) for organizational expenditures also apply to startup expenditures.

Tax Planning Strategies ORGANIZATIONAL EXPENDITURES

FRAMEWORK FOCUS: DEDUCTIONS

Strategy: Maximize Deductible Amounts.

To qualify for the 180-month amortization procedure of § 248, only organizational expenditures incurred in the first taxable year of the corporation can be considered. This rule could prove to be an unfortunate trap for corporations formed late in the year.

EXAMPLE 41

Thrush Corporation is formed in December 2010. Qualified organizational expenditures are incurred as follows: $62,000 in December 2010 and $30,000 in January 2011. If Thrush uses the calendar year for tax purposes, only $62,000 of the organizational expenditures qualify for amortization. ■

A solution to the problem posed by Example 41 may be for Thrush Corporation to adopt a fiscal year that ends on or beyond January 31. All organizational expenditures will then have been incurred before the close of the first tax year.

DETERMINING THE CORPORATE INCOME TAX LIABILITY

LO.8

Compute the corporate income tax.

Corporate Income Tax Rates

Corporate income tax rates have fluctuated widely over the years, with the current rate structure reflecting a significant reduction that occured in the Tax Reform Act of 1986. Refer to the inside front cover of the text for a schedule of current corporate income tax rates. Unlike the individual income tax rate brackets, the corporate income tax brackets are not indexed for inflation.

EXAMPLE 42

Gold Corporation, a calendar year taxpayer, has taxable income of $90,000 for 2010. Its income tax liability is $18,850, determined as follows:

Tax on $75,000	$13,750
Tax on $15,000 × 34%	5,100
Tax liability	$18,850

■

[47] § 195.

For taxable income in excess of $100,000 for any tax year, the amount of the tax is increased by the lesser of (1) 5 percent of the excess or (2) $11,750. In effect, the additional tax means a 39 percent rate for every dollar of taxable income from $100,000 to $335,000.

EXAMPLE 43

Silver Corporation, a calendar year taxpayer, has taxable income of $335,000 for 2010. Its income tax liability is $113,900, determined as follows:

Tax on $100,000	$ 22,250
Tax on $235,000 × 39%	91,650
Tax liability	$113,900

Note that the tax liability of $113,900 is 34% of $335,000. Thus, due to the 39% rate (34% normal rate + 5% additional tax on taxable income between $100,000 and $335,000), the benefit of the lower rates on the first $75,000 of taxable income completely phases out at $335,000. The tax rate drops back to 34% on taxable income between $335,000 and $10 million. ■

Section 11(b)(2) provides that qualified **personal service corporations (PSCs)** are taxed at a flat 35 percent rate on all taxable income. Thus, PSCs do not enjoy the tax savings of the 15 percent to 34 percent brackets applicable to other corporations. For this purpose, a PSC is a corporation that is substantially employee owned. Also, it must engage in one of the following activities: health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting.

LO.9

Explain the rules unique to computing the tax of related corporations.

TAX LIABILITY OF RELATED CORPORATIONS

Members of a controlled group of corporations **(related corporations)** are subject to special rules for computing the income tax, the AMT exemption, and the § 179 election to expense certain depreciable assets.[48] If these restrictions did not exist, the shareholders of a corporation could gain significant tax advantages by splitting a single corporation into *multiple* corporations. The next two examples illustrate the potential *income tax* advantage of multiple corporations.

EXAMPLE 44

Gray Corporation annually yields taxable income of $300,000. The corporate tax on $300,000 is $100,250, computed as follows:

Tax on $100,000	$ 22,250
Tax on $200,000 × 39%	78,000
Tax liability	$100,250

■

EXAMPLE 45

Assume that Gray Corporation in the previous example is divided equally into four corporations. Each corporation would have taxable income of $75,000, and the tax for each (absent the special provisions for related corporations) would be computed as follows:

Tax on $50,000	$ 7,500
Tax on $25,000 × 25%	6,250
Tax liability	$13,750

The total liability for the four corporations would be $55,000 ($13,750 × 4). Consequently, the savings would be $45,250 ($100,250 − $55,000). ■

To preclude the advantages that could be gained by using multiple corporations, the tax law requires special treatment for *controlled groups* of corporations. A comparison of Examples 44 and 45 reveals that the income tax savings that could be

[48] §§ 1561(a) and 179(d)(6).

achieved by using multiple corporations result from having more of the total taxable income taxed at lower rates. To close this potential loophole, the law limits a controlled group's taxable income in the tax brackets below 35 percent to the amount the corporations in the group would have if they were one corporation. Thus, in Example 45, under the controlled corporation rules, only $12,500 (one-fourth of the first $50,000 of taxable income) for each of the four related corporations would be taxed at the 15 percent rate. The 25 percent rate would apply to the next $6,250 (one-fourth of the next $25,000) of taxable income of each corporation. This equal allocation of the $50,000 and $25,000 amounts is required unless all members of the controlled group consent to an apportionment plan providing for an unequal allocation.

Similar limitations apply to controlled groups with respect to the § 179 expense election (see Chapter 5) and to the $40,000 AMT exemption amount (see Chapter 14).

CONTROLLED GROUPS

A **controlled group** of corporations includes parent-subsidiary groups, brother-sister groups, combined groups, and certain insurance companies. Parent-subsidiary controlled groups are discussed in the following section.

Parent-Subsidiary Controlled Group

A **parent-subsidiary controlled group** consists of one or more *chains* of corporations connected through stock ownership with a common parent corporation. The ownership connection can be established through either a *voting power test* or a *value test.* The voting power test requires ownership of stock possessing at least 80 percent of the total voting power of all classes of stock entitled to vote. The value test requires ownership of at least 80 percent of the total value of all shares of all classes of stock of each of the corporations, except the parent corporation, by one or more of the other corporations.[49]

EXAMPLE 46

Aqua Corporation owns 80% of White Corporation. Aqua and White Corporations are members of a parent-subsidiary controlled group. Aqua is the parent corporation and White is the subsidiary. ■

The parent-subsidiary relationship described in Example 46 is easy to recognize because Aqua Corporation is the direct owner of White Corporation. Real-world business organizations are often much more complex, sometimes including numerous corporations with chains of ownership connecting them. In these complex corporate structures, determining whether the controlled group classification is appropriate becomes more difficult. The ownership requirements can be met through direct ownership (refer to Example 46) or through indirect ownership, as illustrated in the following example.

EXAMPLE 47

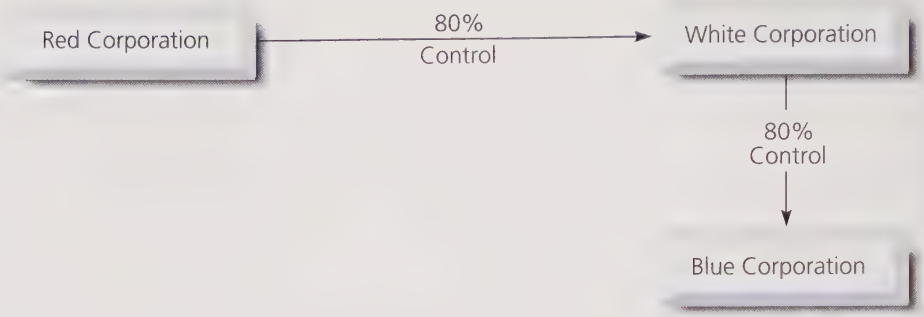
Red Corporation owns 80% of the voting stock of White Corporation, and White Corporation owns 80% of the voting stock of Blue Corporation. Red, White, and Blue Corporations constitute a controlled group in which Red is the common parent and White and Blue are subsidiaries. This parent-subsidiary relationship is diagrammed in Figure 9.3. The same result would occur if Red Corporation, rather than White Corporation, owned the Blue Corporation stock. ■

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft.**



[49] § 1563(a)(1).

FIGURE 9.3 Controlled Groups—Parent-Subsidiary Corporations



Red is the common parent of a parent-subsidiary controlled group consisting of Red, White, and Blue Corporations.

Application of § 482

Congress has recognized that a parent corporation has the power to shift income among its subsidiaries. Likewise, shareholders who control other related groups of corporations can shift income and deductions among the related corporations.

When the true taxable income of a subsidiary or other related corporation has been understated or overstated, the IRS can reallocate the income and deductions of the related corporations under § 482. Section 482 permits the IRS to allocate gross income, deductions, and credits between any two or more organizations, trades, or businesses that are owned or controlled by the same interests. This is appropriate when the allocation is necessary to prevent avoidance of taxes or to reflect income correctly. Controlled groups of corporations, especially multinational corporations, are particularly vulnerable to § 482.

9.5 Procedural Matters

LO.10
Describe the reporting process for corporations.

FILING REQUIREMENTS FOR CORPORATIONS

A corporation must file a Federal income tax return (Form 1120) whether or not it has taxable income.[50] A corporation that was not in existence throughout an entire annual accounting period is required to file a return for the portion of the year during which it was in existence. In addition, a corporation must file a return even though it has ceased to do business if it has valuable claims for which it will bring suit. A corporation is relieved of filing income tax returns only when it ceases to do business and retains no assets.

The return must be filed on or before the fifteenth day of the third month following the close of a corporation's tax year. Corporations with assets of $10 million or more generally are required to file electronically. A regular corporation, other than a PSC, can use either a calendar year or a fiscal year to report its taxable income. The tax year of the shareholders has no effect on the corporation's tax year.

ESTIMATED TAX PAYMENTS

A corporation must make payments of estimated tax unless its tax liability can reasonably be expected to be less than $500. The required annual payment (which includes any estimated AMT liability) is the *lesser* of (1) 100 percent of the corporation's tax for the current year or (2) 100 percent of the tax for the preceding year (if

[50] § 6012(a)(2).

that was a 12-month tax year and the return filed showed a tax liability).[51] Estimated payments can be made in four installments due on or before the fifteenth day of the fourth month, the sixth month, the ninth month, and the twelfth month of the corporate taxable year. The full amount of the unpaid tax is due on the due date of the return without regard to extensions. A corporation failing to pay its required estimated tax payments will be subjected to a nondeductible penalty on the amount by which the installments are less than the tax due.

SCHEDULE M–1—RECONCILIATION OF TAXABLE INCOME AND FINANCIAL NET INCOME

Schedule M–1 of Form 1120 is used to *reconcile* net income as computed for financial accounting purposes with taxable income reported on the corporation's income tax return (commonly referred to as book/tax differences). Schedule M–1 is required of corporations with less than $10 million of total assets.

The starting point on Schedule M–1 is net income (loss) per books. Additions and subtractions are entered for items that affect financial accounting net income and taxable income differently. The following items are entered as additions (see lines 2 through 5 of Schedule M–1 on the next page):

- Federal income tax expense per books (deducted in computing net income per books but not deductible in computing taxable income).
- The excess of capital losses over capital gains (deducted for financial accounting purposes but not deductible by corporations for income tax purposes).
- Income that is reported in the current year for tax purposes but is not reported in computing net income per books (e.g., prepaid income).
- Various expenses that are deducted in computing net income per books but are not deducted in computing taxable income (e.g., charitable contributions in excess of the 10 percent ceiling applicable to corporations).

The following subtractions are entered on lines 7 and 8 of Schedule M–1:

- Income reported for financial accounting purposes but not included in taxable income (e.g., tax-exempt interest).
- Deductions taken on the tax return but not expensed in computing net income per books (e.g., domestic production activities deduction).

The result is taxable income (before the NOL deduction and the dividends received deduction).

EXAMPLE 48

During the current year, Tern Corporation had the following transactions:

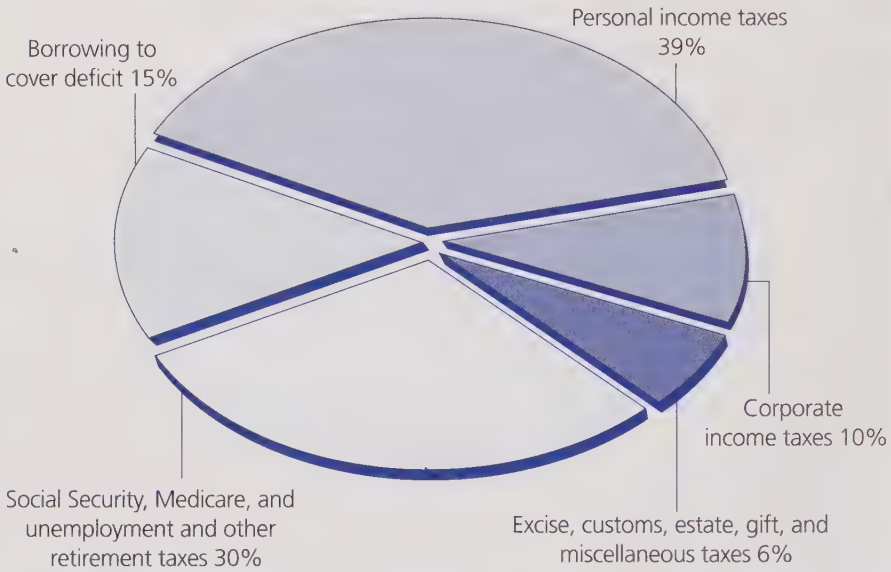
Net income per books (after tax)	$92,400
Taxable income	50,000
Federal income tax expense per books	7,500
Interest income from tax-exempt bonds	5,000
Interest paid on loan, the proceeds of which were used to purchase the tax-exempt bonds	500
Life insurance proceeds received as a result of the death of a key employee	50,000
Premiums paid on key employee life insurance policy	2,600
Excess of capital losses over capital gains	2,000

[51] §§ 6655(d) and (e).

TAX

Sources of Federal Government Revenues

This pie chart shows the relative sizes of the major categories of Federal revenue for fiscal year 2008.



Source: Form 1040 Instructions.

For book and tax purposes, Tern Corporation determines depreciation under the straight-line method. Tern's Schedule M–1 for the current year is as follows:

Schedule M-1 **Reconciliation of Income (Loss) per Books With Income per Return**
Note: Schedule M-3 required instead of Schedule M-1 if total assets are $10 million or more—see instructions

1	Net income (loss) per books	92,400	7	Income recorded on books this year not included on this return (itemize):	
2	Federal income tax per books	7,500		Tax-exempt interest $ 5,000	
3	Excess of capital losses over capital gains	2,000		*Life insurance proceeds on key employee $50,000*	55,000
4	Income subject to tax not recorded on books this year (itemize):		8	Deductions on this return not charged against book income this year (itemize):	
5	Expenses recorded on books this year not deducted on this return (itemize):			a Depreciation $	
	a Depreciation $			b Charitable contributions $	
	b Charitable contributions $				
	c Travel and entertainment $				
	Prem.–life ins. $2,600; Int.–exempt bonds $500	3,100	9	Add lines 7 and 8	55,000
6	Add lines 1 through 5	105,000	10	Income (page 1, line 28)—line 6 less line 9	50,000

Schedule M–2 reconciles unappropriated retained earnings at the beginning of the year with unappropriated retained earnings at year-end. The beginning balance plus net income per books, as entered on line 1 of Schedule M–1, less dividend distributions during the year equals ending retained earnings. Other sources of increases or decreases in retained earnings are also listed on Schedule M–2.

EXAMPLE 43

Assume the same facts as in the preceding example. Tern Corporation's beginning balance in unappropriated retained earnings is $125,000. During the year, Tern

Bridge DISCIPLINE

Bridge to Financial Accounting

Measures of corporate income for financial reporting and income tax purposes differ because the objectives of these measures differ. Income measures for financial reporting purposes are intended to help various stakeholders have a clear view of the corporation's financial position and operational results. Income measures for Federal income tax purposes, on the other hand, must comply with the relevant provisions of the Internal Revenue Code. The tax law is intended not only to raise revenues to fund government operations, but to reflect the objectives of government fiscal policy as well.

As a consequence of these differing objectives, revenue and expense measurements used to determine taxable income may differ from those used in financial reporting. In most cases, differences between book and tax measurements are temporary in nature. Two such temporary differences relate to the different methods of calculating depreciation expense and the limits placed on the deductibility of net capital losses for tax purposes. Permanent differences between book and tax income, such as the dividends received deduction and the domestic production activities deduction, also may exist.

Accounting standards for reporting income tax expenses and liabilities require that the tax impact of *temporary* differences be recognized currently in the financial statements. Because many temporary differences allow a firm to postpone its tax payments to later years, the financial statements must show the amount of the expense that is paid currently and that portion that is to be paid in a later period. The portion of the taxes to be paid in a later period is shown as a liability for such future income taxes. The liability for future income taxes is referred to as a deferred income tax liability.

distributed a cash dividend of $30,000 to its shareholders. Based on these further assumptions, Tern's Schedule M–2 for the current year is as follows:

Schedule M-2 Analysis of Unappropriated Retained Earnings per Books (Line 25, Schedule L)

1	Balance at beginning of year	125,000	5	Distributions: a Cash		30,000
2	Net income (loss) per books	92,400		b Stock		
3	Other increases (itemize):			c Property		
			6	Other decreases (itemize):		
			7	Add lines 5 and 6		30,000
4	Add lines 1, 2, and 3	217,400	8	Balance at end of year (line 4 less line 7)		187,400

■

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4 DIGGING DEEPER

SCHEDULE M–3—NET INCOME (LOSS) RECONCILIATION FOR CORPORATIONS WITH TOTAL ASSETS OF $10 MILLION OR MORE

Corporate taxpayers with total assets of $10 million or more are required to report much greater detail relative to differences between income (loss) reported for financial accounting purposes and income (loss) reported for tax purposes. This expanded reconciliation of book and taxable income (loss) is reported on **Schedule M–3**. Corporations that are not required to file Schedule M–3 may do so voluntarily. Any corporation that files Schedule M–3 is not allowed to file Schedule M–1. Comparison of Schedule M–3 (see **www.irs.gov**) with Schedule M–1 (illustrated in Example 48) reveals the significantly greater disclosure requirements that apply to corporations that are required to file Schedule M–3.

Schedule M–3 is a response, at least in part, to financial reporting scandals, such as Enron and WorldCom. One objective of Schedule M–3 is to create greater transparency between corporate financial statements and tax returns. Another objective

TAX in the NEWS

Impact of IFRS on Schedule M–3

Schedule M–3 is used to reconcile the differences between a corporation's income (loss) reported for financial accounting purposes and its income (loss) reported for tax purposes. In most cases, the financial accounting information reported on Schedule M–3 will be derived from financial statements prepared according to U.S. generally accepted accounting principles (GAAP)—often Form 10–K prepared under GAAP and filed with the Securities and Exchange Commission (SEC). In 2008, the SEC issued a proposal that would require U.S. corporations to adopt the International Financial Reporting Standards (IFRS) beginning in 2014. Further, some U.S. corporations are eligible to voluntarily issue financial statements prepared under IFRS before 2014. There are distinct differences between GAAP and IFRS on the treatment of certain financial income and expense items, and Schedule M–3 may require some modifications to reflect those differences. The IRS is reportedly studying the probable transition from GAAP to IFRS and its impact on many aspects of income tax reporting, including Schedule M–3.

is to identify corporations that engage in aggressive tax practices by requiring that transactions that create book/tax differences be disclosed on corporate tax returns. The increase in transparency and disclosure comes at a cost, however, as the IRS estimates that, on average, almost 89 hours are needed to comply with the requirements of Schedule M–3, and many tax professionals believe that estimate is too low.

Total assets for purposes of the $10 million test and the income and expense amounts required by Schedule M–3 are determined from the taxpayer's financial reports. If the taxpayer files Form 10–K with the Securities and Exchange Commission (SEC), that statement is used. If no 10–K is filed, information from another financial source is used, in the following order: certified financial statements, prepared financial statements, or the taxpayer's books and records.

DIGGING DEEPER 5 6

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

EFFECT OF TAXES ON FINANCIAL STATEMENTS

Given the differences between taxable income and net income per books, what effect do these differences have on an entity's financial statements? How are income tax accruals arrived at and reported for accounting purposes? What other types of disclosures regarding present and potential tax liabilities are required to satisfy the accounting standards? Recall that these and other questions were answered and discussed at length in Chapter 3.

9.6 Summary

The evolution of the check-the-box Regulations has provided taxpayers with a simplified method for determining an entity's tax classification. Nevertheless, taxpayers should not discount the importance of choosing the appropriate form of entity. As demonstrated in this chapter and Chapter 10, a variety of tax provisions applicable to corporations do not extend to other entities. Of particular importance are the different deductions available to corporations and the corporate income tax rate structure. Corporations must also be aware of their levels of debt to avoid equity reclassification. Such reclassification causes deductible interest paid on debt to become nondeductible dividend payments. Equally important are the timing and completeness requirements of the corporate filing provisions. Failure to comply with the appropriate filing provisions may result in heavy penalties and interest.

REFOCUS ON THE BIG PICTURE

Amber, the sole property transferor, must acquire at least 80 percent of the stock issued by the new corporation in order for the transaction to qualify for tax-deferred treatment under § 351. Otherwise, she will recognize $325,000 of taxable gain as a result of the transfer. Even if the requirements of § 351 are met, any corporate debt issued by the corporation will be treated as boot and will result in at least some gain recognition to Amber. Therefore, she must evaluate the cost of recognizing gain now versus the benefit of the corporation obtaining an interest deduction later.

What If?

Can the § 351 transaction be modified to further reduce personal and business tax costs, both at the time of formation and in the future? Several strategies may be worth considering.

- Have Jimmy transfer some property along with the services rendered to the corporation. As long as Jimmy transfers property with more than a relatively small value compared to the value of services performed, Jimmy will be considered part of the control group. This would allow Amber to own less than 80 percent of the new corporation and still have the transaction qualify under § 351.
- Instead of having the corporation issue debt on formation, Amber might withhold certain assets. For example, if the building is not transferred, it can be leased to the corporation. The resulting rent payment would mitigate the double taxation problem by producing a tax deduction for the corporation.
- An additional benefit results if Amber does not transfer the cash basis receivables to the corporation. This approach avoids a tax at the corporate level when they are collected by the corporation and another tax on Amber when the receipts are distributed as a dividend.
- If Amber's sole proprietorship has any accounts payable outstanding at the time of the corporate formation, it could be wise to transfer those to the corporation. The subsequent corporate payment of the liability produces a corporate deduction that will reduce any corporate income tax.

GROWING INTO THE CORPORATE FORM

SUGGESTED READINGS

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Edward J. Schnee and W. Eugene Seago, "New Developments Prompt a New Look at Section 118 Contributions to Capital," *Journal of Taxation*, January 2008.

KEY TERMS

Built-in loss property, 9–20
C corporations, 9–3
Capital contribution, 9–24
Check-the-box Regulations, 9–8
Control, 9–11
Controlled group, 9–33
Dividends received deduction, 9–28
Limited liability company (LLC), 9–7
Limited partnerships, 9–7
Organizational expenditures, 9–30
Parent-subsidiary controlled group, 9–33
Personal service corporations (PSCs), 9–32
Property, 9–10
Regular corporations, 9–3
Related corporations, 9–32
S corporations, 9–3
Schedule M–1, 9–35
Schedule M–3, 9–37
Securities, 9–11
Thin capitalization, 9–27

PROBLEMS

1. **LO.1** Conner is the sole owner of Service Enterprises (SE). SE earned net operating income of $120,000 during the year and made a charitable contribution of $10,000. Conner withdrew $80,000 of the profit from SE. How should Conner report this information on his individual tax return for 2010 if SE is:
   a. An LLC?
   b. A C corporation?
   c. An S corporation?

2. **LO.1** Shareholders in closely held corporations often engage in transactions designed to minimize the double taxation effect of C corporations. Briefly describe the double taxation effect and explain some of the ways double taxation can be minimized.

3. **LO.1** Emu Company, which was formed in 2010, had operating income of $200,000 and operating expenses of $120,000 in 2010. In addition, Emu had a long-term capital loss of $10,000. How does Andrew, the owner of Emu Company, report this information on his individual tax return under the following assumptions?
   a. Emu Company is an S corporation and pays no dividends during the year.
   b. Emu Company is a C corporation and pays no dividends during the year.

4. **LO.1** Ellie and Linda are equal owners in Otter Enterprises, a calendar year business. During the year, Otter Enterprises has $400,000 of gross income and $250,000 of operating expenses. In addition, Otter has tax-exempt interest income of $20,000 and makes distributions to Ellie and Linda of $50,000 each. Discuss the impact of this information on the taxable income of Otter, Ellie, and Linda if Otter is:
   a. A partnership.
   b. An S corporation.
   c. A C corporation.

5. **LO.1** In the current year, Azure Company has $500,000 of net operating income before deducting any compensation or other payment to its sole owner, Sasha. In addition, Azure has a long-term capital gain of $50,000. Sasha has significant income from other sources and is in the 35% marginal tax bracket. Based on this information, determine the income tax consequences to Azure Company and to Sasha during the year for each of the following independent situations.
   a. Azure is a C corporation and pays no dividends or salary to Sasha.
   b. Azure is a C corporation and distributes $100,000 of dividends to Sasha.
   c. Azure is a C corporation and pays $100,000 of salary to Sasha.
   d. Azure is a sole proprietorship and Sasha withdraws $0.
   e. Azure is a sole proprietorship and Sasha withdraws $100,000.

ISSUE ID

6. **LO.2** Emily incorporates her sole proprietorship, but does not transfer a building used by the business to the corporation. Instead, the building is leased to the corporation for an annual rent. What tax reasons might Emily have for not transferring the building to the corporation when the business was incorporated?

7. **LO.2, 4** Sam, Carl, Lucy, and Sylvia form Pine Corporation with the following consideration:

	Consideration Transferred		
	Basis to Transferor	Fair Market Value	Number of Shares Issued
From Sam—			
Inventory	$30,000	$96,000	30*
From Carl—			
Equipment ($30,000 of depreciation taken by Carl in previous years)	45,000	99,000	30**
From Lucy—			
Secret process	15,000	90,000	30
From Sylvia—			
Cash	30,000	30,000	10

*Sam receives $6,000 cash in addition to the 30 shares.

**Carl receives $9,000 cash in addition to the 30 shares.

Assume the value of each share of Pine Corporation stock is $3,000. As to these transactions, provide the following information:

a. Sam's recognized gain or loss. Identify the treatment given to any such gain or loss.
b. Sam's basis in the Pine stock.
c. Pine Corporation's basis in the inventory.
d. Carl's recognized gain or loss and its classification.
e. Carl's basis in the Pine stock.
f. Pine Corporation's basis in the equipment.
g. Lucy's recognized gain or loss.
h. Lucy's basis in the Pine stock.
i. Pine Corporation's basis in the secret process.
j. Sylvia's recognized gain or loss.
k. Sylvia's basis in the Pine stock.

8. **LO.2, 4** Mark and Gail form Maple Corporation with the following consideration:

	Consideration Transferred		
	Basis to Transferor	Fair Market Value	Number of Shares Issued
From Mark—			
Cash	$ 50,000	$ 50,000	
Installment obligation	140,000	250,000	30
From Gail—			
Cash	150,000	150,000	
Equipment	125,000	250,000	
Patent	10,000	300,000	70

The installment obligation has a face amount of $250,000 and was acquired last year from the sale of land held for investment purposes (adjusted basis of $140,000). As to these transactions, provide the following information:

a. Mark's recognized gain or loss.
b. Mark's basis in the Maple Corporation stock.
c. Maple Corporation's basis in the installment obligation.
d. Gail's recognized gain or loss.
e. Gail's basis in the Maple Corporation stock.
f. Maple Corporation's basis in the equipment and the patent.
g. How would your answers to the preceding questions change if Mark received common stock and Gail received preferred stock?
h. How would your answers change if Gail was a partnership?

DECISION MAKING

9. **LO.2** Jane, Jon, and Clyde incorporate their respective businesses and form Starling Corporation. On March 1 of the current year, Jane exchanges her property (basis of $50,000 and value of $150,000) for 150 shares in Starling Corporation. On April 15, Jon exchanges his property (basis of $70,000 and value of $500,000) for 500 shares in Starling. On May 10, Clyde transfers his property (basis of $90,000 and value of $350,000) for 350 shares in Starling.
   a. If the three exchanges are part of a prearranged plan, what gain will each of the parties recognize on the exchanges?
   b. Assume Jane and Jon exchanged their property for stock four years ago while Clyde transfers his property for 350 shares in the current year. Clyde's transfer is not part of a prearranged plan with Jane and Jon to incorporate their businesses. What gain will Clyde recognize on the transfer?
   c. Returning to the original facts, if the property that Clyde contributes has a basis of $490,000 (instead of $90,000), how might the parties otherwise structure the transaction?

COMMUNICATIONS

10. **LO.2** Ken Henderson (1635 Maple Street, Syracuse, NY 13201) exchanges property, basis of $30,000 and fair market value of $600,000, for 60% of the stock of Red Corporation. The other 40% is owned by Joy Perry, who acquired her stock several years ago. You represent Ken, who asks whether he must report gain on the transfer. Prepare a letter to Ken and a memorandum for the tax files documenting your response.

ISSUE ID

11. **LO.2** Barbara exchanges property (basis of $20,000 and fair market value of $500,000) for 65% of the stock of Pelican Corporation. Alice, Barbara's daughter, who acquired her stock last year, owns the other 35% of Pelican. What are the tax issues?

12. **LO.2** Juan organized Loon Corporation 10 years ago. He contributed property worth $1 million (basis of $300,000) for 2,000 shares of stock in Loon (representing 100% ownership). Juan later gave each of his children, Julie and Rachel, 500 shares of the stock. In the current year, Juan transfers property worth $400,000 (basis of $75,000) to Loon for 1,000 more of its shares. What gain, if any, will Juan recognize on the transfer?

13. **LO.2, 4** Dan and Vera form Oriole Corporation. Dan transfers land (worth $200,000, basis of $60,000) for 50% of the stock in Oriole. Vera transfers machinery (worth $150,000, adjusted basis of $30,000) and provides services (worth $50,000) for the remaining 50% of the stock.
   a. Will the transfers qualify under § 351?
   b. What are the tax consequences to Dan and Vera?
   c. What is Oriole Corporation's basis in the land and the machinery?

14. **LO.2, 4** Assume in Problem 13 that the property Vera transfers is worth $10,000 (basis of $6,500) and her services are worth $190,000. Further, assume that Vera's services involve organizing the corporation. What are the consequences to Dan, Vera, and Oriole Corporation?

DECISION MAKING

15. **LO.2** Monica Roberts owns 50% of the stock of Condor Corporation. She and the other 50% shareholder, Rachel Powell, have decided that additional contributions of capital are needed if Condor is to remain successful in its competitive industry. The two shareholders have agreed that Monica will contribute assets having a value of $300,000 (adjusted basis of $45,000) in exchange for additional shares of stock. After the transaction, Monica will hold 75% of Condor Corporation and Rachel's interest will fall to 25%.
   a. What gain is realized on the transaction? How much of the gain will be recognized?
   b. Monica is not satisfied with the transaction as proposed. How would the consequences change if Rachel agrees to transfer $100 of cash in exchange for additional stock? In this case, Monica will own slightly less than 75% of Condor and Rachel's interest will be slightly more than 25%.
   c. If Monica still is not satisfied with the result, what should be done to avoid any gain recognition?

16. **LO.2, 3, 4** Lori was engaged in a service business as a sole proprietor and reported her income on the cash basis. On February 1, 2010, she incorporates the business. In exchange for all of the assets and liabilities of her business, Lori obtains all of the stock of newly formed Green Corporation. Included in the transfer are the unrealized receivables

and payables of the business. The balance sheet of Green immediately following its formation is as follows:

Green Corporation
Balance Sheet
February 1, 2010

Assets

	Basis to Green	Fair Market Value
Cash	$ 80,000	$ 80,000
Unrealized accounts receivable	–0–	240,000
Equipment (cost $180,000; depreciation claimed $60,000)	120,000	320,000
Building (straight-line depreciation)	160,000	400,000
Land	40,000	160,000
Total	$400,000	$1,200,000

Liabilities and Stockholder's Equity

Liabilities:	
Accounts payable—trade	$ 120,000
Notes payable—bank	360,000
Stockholder's equity:	
Common stock	720,000
Total	$1,200,000

Discuss the tax consequences of the incorporation to Lori and to Green Corporation.

17. **LO.2, 3, 4** Four years ago, Gene exchanged commercial real estate worth $1.5 million (basis of $300,000) and subject to a mortgage of $200,000, for land worth $1.15 million, subject to a mortgage of $150,000, and cash of $300,000. In the current year, Gene transfers the land that he received in the exchange to newly formed Bronze Corporation for all of its stock. Bronze Corporation assumes the original mortgage on the land, current face amount of $100,000, and a second mortgage, face amount of $20,000. Gene had placed the second mortgage on the land to secure the purchase of some equipment that he used in this business. What are the tax issues? **ISSUE ID**

18. **LO.2, 3, 4** Allie forms Blue Corporation by transferring land with a basis of $125,000 (fair market value of $775,000). The land is subject to a mortgage of $375,000. One month prior to incorporating Blue, Allie had borrowed $100,000 for personal purposes and had given the lender a second mortgage on the land. Blue Corporation issues stock worth $300,000 to Allie and assumes both mortgages on the land.
    a. What are the tax consequences to Allie and to Blue Corporation?
    b. How would the tax consequences to Allie differ if she had not transferred the second mortgage of $100,000?

19. **LO.2, 3, 4** Frank transfers the following assets to Peach Corporation in exchange for all of its stock. (Assume neither Frank nor Peach plans to make any special tax elections at the time of incorporation.) **DECISION MAKING**

Assets	Frank's Adjusted Basis	Fair Market Value
Inventory	$ 60,000	$100,000
Delivery vehicles	150,000	105,000
Shelving	80,000	65,000

a. What is Frank's recognized gain or loss?
b. What is Frank's basis in the stock?
c. What is Peach's basis in the inventory, delivery vehicles, and shelving?
d. If Frank has no intentions of selling his Peach stock for at least 15 years, what action would you recommend that Frank and Peach Corporation consider? How does this change the previous answers?

20. **LO.2, 3, 4** Fay, a sole proprietor, is engaged in a cash basis, service business. In the current year, she incorporates the business to form Robin Corporation. She transfers assets with a basis of $400,000 (fair market value of $1.2 million), a bank loan of $360,000 (which Robin assumes), and $80,000 in trade payables in return for all of Robin's stock. What are the tax consequences of the incorporation of the business?

ISSUE ID

21. **LO.2** Julie and her son, Wyatt, have been operating a neighborhood garden center. Julie formed the business in 1996 as a sole proprietorship, and it has been very successful. It currently has assets with a fair market value of $250,000 and a basis of $180,000. On the advice of her tax accountant, Julie decides to incorporate her business. Because of Wyatt's loyalty, Julie would like him to have shares in the corporation. What are the relevant tax issues?

ETHICS AND EQUITY

22. **LO.2** Early in the year, Charles, Lane, and Tami form the Harrier Corporation for the express purpose of developing a shopping center. All parties are experienced contractors, and they transfer various business assets (e.g., building materials, land) to Harrier in exchange for all of its stock. Three months after it is formed, Harrier purchases two cranes from Lane for their fair market value of $400,000 by issuing four annual installment notes of $100,000 each. Since the adjusted basis of the cranes is $550,000, Lane plans to recognize a § 1231 loss of $150,000 in the year of the sale. Does Lane have any potential income tax problem with this plan?

23. **LO.2, 4** Sara and Jane form Wren Corporation. Sara transfers property, basis of $25,000 and fair market value of $200,000, for 50 shares in Wren Corporation. Jane transfers property, basis of $10,000 and fair market value of $185,000, and agrees to serve as manager of Wren for one year; in return, Jane receives 50 shares in Wren. The value of Jane's services to Wren is $15,000.
a. What gain or income will Sara and Jane recognize on the exchange?
b. What basis will Wren Corporation have in the property transferred by Sara and Jane? How should Wren treat the value of the services Jane renders?

24. **LO.2, 4** Assume in Problem 23, that Jane receives the 50 shares of Wren Corporation stock in consideration for the appreciated property and for providing legal services in organizing the corporation. The value of Jane's services is $15,000.
a. What gain or income does Jane recognize?
b. What is Wren Corporation's basis in the property transferred by Jane? How should Wren treat the value of the services Jane renders?

25. **LO.2, 4** On January 8, 2010, Carol transferred machinery worth $100,000 (adjusted basis of $20,000) to a controlled corporation, Lark. The transfer qualified under § 351. Carol had deducted $85,000 of depreciation on the machinery while it was used in her proprietorship. On November 16, 2010, Lark Corporation sells the machinery for $95,000. What are the tax consequences to Carol and to Lark Corporation on the sale of the machinery?

26. **LO.5** Locust Corporation desires to set up a distribution facility in a southern state. After considerable negotiations with a small town in Alabama, Locust accepts the following offer: land (fair market value of $3 million) and cash of $1 million.
a. How much gain, if any, must Locust Corporation recognize?
b. What basis will Locust Corporation have in the land?
c. Within one year of the contribution, Locust constructs a building for $800,000 and purchases inventory for $200,000. What basis will Locust Corporation have in each of these assets?

CRITICAL THINKING

COMMUNICATIONS

27. **LO.6** Emily Patrick (36 Paradise Road, Northampton, MA 01060) formed Teal Corporation a number of years ago with an investment of $200,000 of cash, for which she received $20,000 in stock and $180,000 in bonds bearing interest of 8% and maturing in nine years. Several years later, Emily lent the corporation an additional $50,000 on open account. In the current year, Teal Corporation becomes insolvent and is declared bankrupt. During the corporation's existence, Emily was paid an annual salary of $60,000. Write a letter to Emily in which you explain how she should treat her losses for tax purposes.

28. **LO.7** In each of the following independent situations, determine the dividends received deduction. Assume that none of the corporate shareholders owns 20% or more of the stock in the corporations paying the dividends.

	Green Corporation	Orange Corporation	Yellow Corporation
Income from operations	$ 500,000	$ 500,000	$ 500,000
Expenses from operations	(450,000)	(550,000)	(510,000)
Qualifying dividends	100,000	100,000	100,000

29. **LO.7** Owl Corporation was formed on October 1, 2010. Qualifying organizational expenses were incurred and paid as follows:

Incurred and paid in October 2010	$20,000
Incurred in October 2010 but paid in January 2011	15,000
Incurred and paid in February 2011	4,000

Assuming that Owl Corporation elects under § 248 to expense and amortize its organizational expenditures, what amount may be deducted in the corporation's first tax year under each of the following assumptions?

a. Owl Corporation adopts a calendar year and the cash basis of accounting for tax purposes.
b. Same as (a), except that Owl Corporation chooses a fiscal year of October 1–September 30.
c. Owl Corporation adopts a calendar year and the accrual basis of accounting for tax purposes.
d. Same as (c), except that Owl Corporation chooses a fiscal year of October 1–September 30.

30. **LO.7** Egret Corporation, a calendar year C corporation, was formed on June 7, 2010, and opened for business on September 1, 2010. After its formation but prior to opening for business, Egret incurred the following expenditures:

Accounting	$ 4,000
Advertising	9,500
Employee payroll	12,000
Rent	9,000
Utilities	2,000

What is the maximum amount of these expenditures that Egret can deduct in 2010?

31. **LO.8** In each of the following *independent* situations, determine the corporation's income tax liability. Assume that all corporations use a calendar year for tax purposes and that the tax year involved is 2010.

	Taxable Income
Purple Corporation	$ 65,000
Azul Corporation	210,000
Pink Corporation	335,000
Turquoise Corporation	5,100,000
Teal Corporation	19,500,000

CRITICAL THINKING

32. **LO.9** The outstanding stock in Red, Blue, and Green Corporations, each of which has only one class of stock, is owned by the following unrelated individuals:

	Corporations		
Shareholders	**Red**	**Blue**	**Green**
Marrin	20%	10%	30%
Murray	10%	50%	20%
Moses	50%	30%	35%

a. Determine whether Red, Blue, and Green Corporations constitute a brother-sister controlled group.
b. Assume that Murray does not own stock in any of the corporations. Would a brother-sister controlled group exist?

33. **LO.10** Albatross Corporation, a calendar year and accrual method taxpayer, provides the following information and asks you to prepare Schedule M–1 for 2010:

Net income per books (after-tax)	$257,950
Federal income tax per books	41,750
Tax-exempt interest income	8,000
Life insurance proceeds received as a result of death of corporate president	150,000
Nondeductible penalties	2,000
Interest on loan to purchase tax-exempt bonds	1,500
Excess of capital losses over capital gains	4,000
Premiums paid on life insurance policy on life of Albatross's president	7,800
Domestic production activities deduction	4,800
Excess of tax depreciation over book depreciation	2,200

34. **LO.10** The following information for 2010 relates to Sparrow Corporation, a calendar year, accrual method taxpayer.

Net income per books (after-tax)	$119,738
Federal income tax per books	49,862
Tax-exempt interest income	7,500
MACRS depreciation in excess of straight-line depreciation used for financial accounting purposes	10,000
Charitable contribution in excess of taxable income limitation	8,750
Premiums paid on life insurance policy on the president (Sparrow is the beneficiary of the policy)	6,250
Interest on loan to purchase tax-exempt bonds	3,700

Based on the above information, use Schedule M–1 of Form 1120, which is available on the IRS website, to determine Sparrow's taxable income for 2010.

35. **LO.10** For years ending after December 31, 2004, corporate taxpayers with total assets of $10 million or more are required to report much greater detail relative to differences between book and taxable income (loss). What were the government's objectives in creating this reporting requirement?

CRITICAL THINKING

36. **LO.10** Pro Golf Warehouse, Inc. (PGW), sells golf equipment throughout the United States. PGW also sells golf equipment in Canada through its subsidiary, Canadian Golf Warehouse (CGW), which is organized as a Canadian corporation. In addition, PGW has an American subsidiary, Tennis Supplies, Inc. (TSI). PGW includes income (loss) from both subsidiaries on its audited financial statements, which show net income of $97 million in 2010. CGW, which is not consolidated by PGW for U.S. tax purposes, had net income of $31 million. TSI, which is consolidated for U.S. tax purposes, had a loss of $16 million. How is this information reported on Schedule M–3?

37. **LO.10** In the current year, PGW incurs $50,000 of nondeductible fines and penalties. Its depreciation expense is $245,000 for financial statement purposes and $310,000 for tax purposes. How is this information reported on Schedule M–3?

CRITICAL THINKING

38. **LO.10** In January 2010, PGW established an allowance for uncollectible accounts (bad debt reserve) of $110,000 on its books and increased the allowance by $160,000 during the year. As a result of a client's bankruptcy, PGW decreased the allowance by $90,000 in November 2010. PGW deducted the $270,000 of increases to the allowance on its 2010 income statement, but was not allowed to deduct that amount on its tax return. On its 2010 tax return, the corporation was allowed to deduct the $90,000 actual loss sustained because of its client's bankruptcy. On its financial statements, PGW treated the $270,000 increase in the bad debt reserve as an expense that gave rise to a temporary difference. On its 2010 tax return, PGW took a $90,000 deduction for bad debt expense. How is this information reported on Schedule M–3?

CRITICAL THINKING

COMPREHENSIVE TAX RETURN PROBLEM

39. On November 1, 2005, Janet Morton and Kim Wong formed Pet Kingdom, Inc., to sell pets and pet supplies. Pertinent information regarding Pet Kingdom is summarized as follows:

TAX RETURN PROBLEM

H&R BLOCK At Home

- Pet Kingdom's business address is 1010 Northwest Parkway, Dallas, TX 75225; its telephone number is (214) 555-2211; and its e-mail address is petkingdom@pki.com.
- The employer identification number is 11–1111111, and the principal business activity code is 453910.
- Janet and Kim each own 50% of the common stock; Janet is president and Kim is vice president of the company. No other class of stock is authorized.
- Both Janet and Kim are full-time employees of Pet Kingdom. Janet's Social Security number is 123–45–6789, and Kim's Social Security number is 987–65–4321.
- Pet Kingdom is an accrual method, calendar year taxpayer. Inventories are determined using FIFO and the lower of cost or market method. Pet Kingdom uses the straight-line method of depreciation for book purposes and accelerated depreciation (MACRS) for tax purposes.
- During 2009, the corporation distributed cash dividends of $200,000.

Pet Kingdom's financial statements for 2009 are shown below.

Income Statement

Income			
Gross sales			$ 4,600,000
Sales returns and allowances			(160,000)
Net sales			$ 4,440,000
Cost of goods sold			(1,840,000)
Gross profit			$ 2,600,000
Dividends received from stock investments in less-than-20%-owned U.S. corporations			35,000
Interest income:			
State bonds	$ 12,000		
Certificates of deposit	16,000		28,000
Total income			$ 2,663,000
Expenses			
Salaries—officers:			
Janet Morton	$210,000		
Kim Wong	210,000	$420,000	
Salaries—clerical and sales		580,000	
Taxes (state, local, and payroll)		190,000	
Repairs and maintenance		112,000	

Interest expense:			
Loan to purchase state bonds	$ 7,000		
Other business loans	174,000	$181,000	
Advertising		46,000	
Rental expense		86,000	
Depreciation*		80,000	
Charitable contributions		30,000	
Employee benefit programs		48,000	
Premiums on term life insurance policies on lives of Janet and Kim; Pet Kingdom is the designated beneficiary		32,000	
Total expenses			($1,805,000)
Net income before taxes			$ 858,000
Federal income tax			(282,370)
Net income per books			$ 575,630

*Depreciation for tax purposes is $110,000. You are not provided enough detailed data to complete a Form 4562 (depreciation). If you solve this problem using H&R BLOCK At Home, enter the amount of depreciation on line 20 of Form 1120.

Balance Sheet

Assets	January 1, 2009	December 31, 2009
Cash	$ 960,000	$ 680,000
Trade notes and accounts receivable	1,650,000	1,838,000
Inventories	2,200,000	2,424,000
Stock investment	900,000	900,000
State bonds	300,000	300,000
Certificates of deposit	350,000	350,000
Prepaid Federal tax	—	3,630
Buildings and other depreciable assets	4,365,000	4,365,000
Accumulated depreciation	(485,000)	(565,000)
Land	650,000	650,000
Other assets	112,000	102,800
Total assets	$11,002,000	$11,048,430

Liabilities and Equity	January 1, 2009	December 31, 2009
Accounts payable	$ 1,850,000	$ 1,579,800
Other current liabilities	142,000	123,000
Mortgages	3,700,000	3,660,000
Capital stock	2,000,000	2,000,000
Retained earnings	3,310,000	3,685,630
Total liabilities and equity	$11,002,000	$11,048,430

During 2009, Pet Kingdom made estimated tax payments of $71,500 each quarter to the IRS. Prepare a Form 1120 for Pet Kingdom for tax year 2009. Suggested software: H&R BLOCK At Home.

Bridge DISCIPLINE

1. Charles is planning to invest $10,000 in a venture whose management is undecided as to whether it should be structured as a regular corporation or as a partnership. Charles will hold a 10% interest in the entity. Determine the treatment to Charles if the entity is a corporation and if it is a partnership. In the analysis, assume Charles is in the 35% marginal tax bracket, and the entity, if operating as a corporation, is in the 34% marginal tax bracket. Also, assume that the passive activity rules do not apply to Charles.
   a. If the entity incurs an $80,000 operating loss in year 1, what is Charles's cash outflow if the entity is a corporation? A partnership?
   b. In year 2, the entity earns operating income of $200,000 and makes no distributions to any of the owners. What is the tax burden on Charles if the investment is a corporation? A partnership?
   c. In year 3, the entity earns operating income of $200,000 and distributes all of that year's after-tax proceeds to the owners. What amount of cash is available to Charles if the entity operates as a corporation (assume any distribution is a qualified dividend)? A partnership?

2. On your review of the books and records of Ridge Corporation, you note the following information pertaining to its tax provision.

Net income per books	$525,400
Book income tax expense	234,600
Dividends received deduction	70,000
Capital gains	50,000
Capital losses	(60,000)
MACRS depreciation	80,000
Book depreciation	65,000

   a. Calculate Ridge's taxable income and Federal income tax liability for the year.
   b. Calculate Ridge's deferred income tax liability.

RESEARCH PROBLEMS

THOMSON REUTERS
Checkpoint® Student Edition

Note: Solutions to Research Problems can be prepared by using the **Checkpoint® Student Edition** online research product, which is available to accompany this text. It is also possible to prepare solutions to the Research Problems by using tax research materials found in a standard tax library.

Research Problem 1. Terri Smith, an entrepreneur, has come to you seeking advice concerning the deductibility of a $435,000 bad debt expense. For a number of years, Terri has run several businesses in the entertainment industry, even though she was formally educated as an attorney. She has accumulated significant wealth and built a solid credit history. This enables her to lend money to her businesses when they are in need of funds. In fact, she has lent funds to her companies more than 125 times during the past 10 years. This year, Terri learns that one of her companies will not be able to repay a $435,000 loan she made three years ago. Describe how Terri could report this matter on her current income tax return.

COMMUNICATIONS

Research Problem 2. A new client, Southwest Grocers, is a calendar year C corporation that owns and operates a chain of grocery stores. Southwest Grocers is interested in donating food inventory to one or more charitable organizations. In some cases, the donated items would consist of dented canned food and fungible food items (e.g., baked goods) nearing their freshness expiration dates. Inedible food or food past its expiration date would not be included in any donation. Prepare an outline detailing the information you would provide to Southwest Grocers regarding charitable contributions of food inventory. Be sure to include support for the content of your outline.

Research Problem 3. Joel has operated his business as a sole proprietorship for many years but has decided to incorporate the business in order to limit his exposure to personal liability. The balance sheet of his business is as follows:

	Adjusted Basis	Fair Market Value
Assets:		
Cash	$ 50,000	$ 50,000
Accounts receivable	40,000	40,000
Inventory	30,000	60,000
Fixed assets	10,000	200,000
	$130,000	$350,000
Liabilities:		
Trade accounts payable	$ 25,000	$ 25,000
Notes payable	175,000	175,000
Owner's equity	(70,000)	150,000
	$130,000	$350,000

One problem with this plan is that the liabilities of his sole proprietorship exceed the basis of the assets to be transferred to the corporation by $70,000 ($200,000 − $130,000). Therefore, Joel would be required to recognize a gain of $70,000. He is not pleased with this result and asks you about the effect of drawing up a $70,000 note that he would transfer to the corporation. Would the note, which promises a future payment to the corporation of $70,000, enable Joel to avoid recognition of the gain?

Partial list of research aids:
§ 357(c).



Use the tax resources of the Internet to address the following questions. Do not restrict your search to the Web, but include a review of newsgroups and general reference materials, practitioner sites and resources, primary sources of the tax law, chat rooms and discussion groups, and other opportunities.

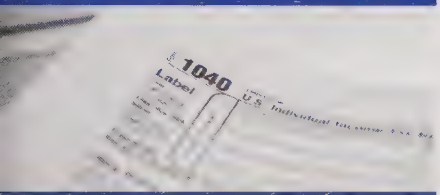
COMMUNICATIONS

Research Problem 4. In recent years, there has been much discussion of U.S. corporate taxation and its effect on the country's global competitiveness. Using the Internet as your sole research source, prepare an outline comparing U.S. corporate taxation with that of other industrialized countries. In addition to comparing corporate income tax rates, your outline should also address the effective corporate tax rates of these countries.

Research Problem 5. Limited liability company (LLC) status has become a very popular form of operating a business in recent years. Investigate how the growing popularity of LLC status has affected the relative number of new businesses that have chosen to operate as a corporation.

CHAPTER 10

Corporations: Earnings & Profits and Distributions



LEARNING OBJECTIVES

After completing Chapter 10, you should be able to:

LO.1 Understand the role that earnings and profits play in determining the **tax treatment of distributions**. **(pp.10-2 to 10-3)**

LO.2 Compute a corporation's **earnings and profits**. **(pp.10-3 to 10-7)**

LO.3 Apply the rules for **assigning earnings and profits to distributions**. **(pp.10-7 to 10-11)**

LO.4 Understand the tax effects of **property dividends** on the recipient shareholder and the corporation making the distribution. **(pp.10-12 to 10-15)**

LO.5 Understand the nature and treatment of **constructive dividends**. **(pp.10-15 to 10-20)**

LO.6 Distinguish between taxable and nontaxable **stock dividends**. **(pp.10-20 to 10-21)**

LO.7 Understand the tax treatment of **stock redemptions and corporate liquidations**. **(pp.10-21 to 10-26)**

TAX *Talk*

The relative stability of profits after taxes is evidence that the corporation profits tax is, in effect, almost entirely shifted; the government simply uses the corporation as a tax collector.

—K. E. Boulding

OUTLINE

10.1 Corporate Distributions—Overview, 10-2
10.2 Earnings and Profits (E & P), 10-3
Computation of E & P, 10-4
Summary of E & P Adjustments, 10-7
Allocating E & P to Distributions, 10-7
10.3 Property Dividends, 10-12
Property Dividends—Effect on the Shareholder, 10-12
Property Dividends—Effect on the Corporation, 10-13
10.4 Constructive Dividends, 10-15
Types of Constructive Dividends, 10-15
Tax Treatment of Constructive Dividends, 10-18
10.5 Stock Dividends, 10-20
10.6 Stock Redemptions, 10-21
10.7 Corporate Liquidations, 10-24
The Liquidation Process, 10-24
Liquidating and Nonliquidating Distributions Compared, 10-25
10.8 Restrictions on Corporate Accumulations, 10-26

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TAXING CORPORATE DISTRIBUTIONS

Now in its third year of operations, and after two years of losing money, Amber and Jimmy's corporation has had a very profitable year. To share its profits with its two shareholders (Amber owns 80 percent and Jimmy owns 20 percent), on December 31 the corporation distributes cash of $80,000 to Amber and land with a basis of $10,000 and a fair market value of $25,000 to Jimmy. The land is subject to a mortgage of $5,000, which is assumed by Jimmy.

At the beginning of the year, the company has a $30,000 deficit in accumulated earnings and profits (E & P). The current-year E & P before the distributions are made is $150,000. Amber and Jimmy have come to you and would like to know the tax effects of the distributions made during the year. **Read the chapter and formulate your response.**

Generally, a corporation cannot deduct distributions made to its shareholders. In contrast, shareholders may be required to treat distributions as fully subject to tax, a nontaxable recovery of capital, or capital gain.

Since distributions provide no deduction to the paying corporation and often require income recognition by the shareholders, a double tax seemingly results (i.e., at both the corporate and the shareholder levels). Because of the possibility of a double tax when dealing with corporations, the tax treatment of distributions often raises issues such as the following.

- The availability of earnings to be distributed.
- The basis of the shareholder's stock.
- The character of the property being distributed.
- Whether the shareholder gives up ownership in return for the distribution.
- Whether the distribution is liquidating or nonliquidating.

10.1 Corporate Distributions—Overview

LO.1

Understand the role that earnings and profits play in determining the tax treatment of distributions.

To the extent that a distribution is made from corporate earnings and profits (E & P), the shareholder is deemed to receive a **dividend**, usually taxed in a preferential manner.[1] Generally, corporate distributions are presumed to be paid out of E & P (defined later in this chapter) and are treated as dividends, *unless* the parties to the transaction can show otherwise.

The portion of a corporate distribution that is not taxed as a dividend (because of insufficient E & P) is nontaxable to the extent of the shareholder's basis in the stock.

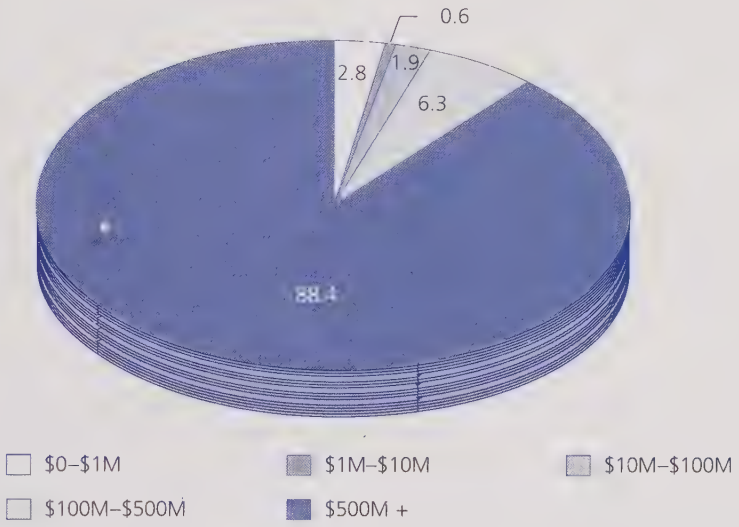
[1] §§ 301(c)(1) and 316(a). Corporate shareholders claim a dividends received deduction. Others typically pay a tax on dividends at a maximum 15% rate.

TAX

WHO PAYS DIVIDENDS?

The vast majority of dividends paid by C corporations come from the very largest enterprises (measured by size of total assets) as reported on Forms 1120. Only about one-eighth of all of the dividend payments made during a tax year are made by C corporations with less than $500 million in total assets.

Percentage of All Dividends Paid by Size of Corporate Assets (2006)



The stock basis is reduced accordingly. The excess of the distribution over the shareholder's basis is treated as a gain from the sale or exchange of the stock.[2]

EXAMPLE 3

At the beginning of the year, Amber Corporation (a calendar year taxpayer) has accumulated E & P of $30,000. The corporation has no current E & P. During the year, the corporation distributes $40,000 to its *equal* shareholders, Bob and Bonnie (i.e., each receives $20,000). Only $30,000 of the $40,000 distribution is a taxable dividend. Suppose Bob's basis in his stock is $8,000, while Bonnie's basis is $4,000. Under these conditions, Bob recognizes a taxable dividend of $15,000 and reduces the basis of his stock from $8,000 to $3,000. The $20,000 Bonnie receives from Amber Corporation is accounted for as follows.

- Taxable dividend of $15,000.
- Reduction in stock basis from $4,000 to zero.
- Taxable gain of $1,000. ■

10.2 EARNINGS AND PROFITS (E & P)

LO.2

Compute a corporation's earnings and profits.

The notion of **earnings and profits** is similar in many respects to the financial accounting concept of retained earnings. Both are measures of the firm's accumulated capital. However, these two concepts differ in a fundamental way. The computation of retained earnings is based on financial accounting rules, while E & P is determined using rules specified in the tax law.

E & P fixes the upper limit on the amount of dividend income that shareholders must recognize as a result of a distribution by the corporation. In this sense, E & P

[2] § 301(c).

represents the corporation's economic ability to pay a dividend without impairing its capital. Thus, the effect of a specific transaction on the E & P account often can be determined by considering whether the transaction increases or decreases the corporation's capacity to pay a dividend.

COMPUTATION OF E & P

The Code does not explicitly define the term *earnings and profits.* Instead, a series of adjustments to taxable income are identified to provide a measure of the corporation's economic income.[3] In general, E & P determinations are applied in the same manner for cash and accrual basis taxpayers.

Accumulated E & P is fixed as of the beginning of the tax year, which is the sum of the undistributed earnings of the entity since February 28, 1913. **Current E & P** is that portion of E & P attributable to the current tax year's operations. It is computed by using the corporation's Federal taxable income and then applying a series of adjustments to more closely approximate the cash flow of the entity.[4]

Additions to Taxable Income

To determine current E & P, one must add certain previously excluded income items back to taxable income. Included among these positive adjustments are interest income on municipal bonds, excluded life insurance proceeds (in excess of cash surrender value), and Federal income tax refunds from taxes paid in prior years.

In addition to excluded income items, the dividends received deduction and the domestic production activities deduction are added back to taxable income to determine E & P. Neither of these deductions decreases the corporation's assets. Instead, they are partial exclusions for specific types of income (dividend income and income from domestic production activities). Since they do not impair the corporation's ability to pay dividends, they do not reduce E & P.

EXAMPLE 3

A corporation collects $100,000 on a key employee life insurance policy (the corporation is the owner and beneficiary of the policy). At the time the policy matured on the death of the insured employee, it possessed a cash surrender value of $30,000. None of the $100,000 is included in the corporation's taxable income, but $70,000 is added to taxable income when computing current E & P. ■

Subtractions from Taxable Income

Some of the corporation's nondeductible expenditures are subtracted from taxable income to arrive at E & P. These negative adjustments include the nondeductible portion of meals and entertainment expenses, related-party losses, expenses incurred to produce tax-exempt income, Federal income taxes paid, nondeductible key employee life insurance premiums (net of increases in cash surrender value), and nondeductible fines, penalties, and lobbying costs.

EXAMPLE 4

A corporation sells property (basis of $10,000) to its sole shareholder for $8,000. Because of § 267 (disallowance of losses on sales between related parties), the $2,000 loss cannot be deducted in arriving at the corporation's taxable income. But since the overall economic effect of the transaction is a decrease in the corporation's assets by $2,000, the loss reduces the current E & P for the year of the sale. ■

EXAMPLE 5

A corporation pays a $10,000 premium on a key employee life insurance policy covering the life of its president. As a result of the payment, the cash surrender value of the policy is increased by $7,000. Although none of the $10,000 premium is deductible for tax purposes, current E & P is reduced by $3,000. ■

[3] Reg. § 1.312–6(a).

[4] Section 312 describes many of the adjustments to taxable income necessary to determine E & P. Regulation § 1.312–6 addresses the effect of accounting methods on E & P.

Timing Adjustments

Some E & P adjustments shift the effect of a transaction from the year of its inclusion in or deduction from taxable income to the year in which it has an economic effect on the corporation. Charitable contribution carryovers, net operating loss carryovers, and capital loss carryovers all give rise to this kind of adjustment.

During 2010, Raven Corporation makes charitable contributions, $12,000 of which cannot be deducted in arriving at the taxable income for the year because of the 10% taxable income limitation. Consequently, the $12,000 is carried forward to 2011 and fully deducted in that year. The excess charitable contribution reduces the corporation's current E & P for 2010 by $12,000 and increases its current E & P for 2011, when the deduction is allowed, by a like amount. The increase in E & P in 2011 is necessary because the charitable contribution carryover reduces the taxable income for that year (the starting point for computing E & P) and already has been taken into account in determining the E & P for 2010. ■

Gains and losses from property transactions generally affect the determination of E & P only to the extent that they are recognized for tax purposes. Thus, gains and losses deferred under the like-kind exchange provision and deferred involuntary conversion gains do not affect E & P until recognized. Accordingly, no timing adjustment is required for these items.

Accounting Method Adjustments

In addition to the above adjustments, accounting methods used for determining E & P are generally more conservative than those allowed under the income tax rules. For example, the installment method is not permitted for E & P purposes even though, in some cases, it is allowed when computing taxable income. Thus, an adjustment is required for the deferred gain attributable to sales of property made during the year under the installment method. Specifically, all principal payments are treated as having been received in the year of sale.[5]

In 2010, Cardinal Corporation, a calendar year taxpayer, sells unimproved real estate (basis of $20,000) for $100,000. Under the terms of the sale, Cardinal will receive two annual payments of $50,000, beginning in 2011, each with interest of 9%. Cardinal does not elect out of the installment method.

Since Cardinal's taxable income for 2010 will not reflect any of the gain from the sale, the corporation must make an $80,000 positive adjustment for 2010 (the deferred gain from the sale) in computing E & P. Similarly, $40,000 negative adjustments will be required in 2011 and 2012 when the deferred gain is recognized under the installment method. ■

The alternative depreciation system (ADS) is used in computing E & P.[6] This method requires straight-line depreciation over a recovery period equal to the Asset Depreciation Range (ADR) midpoint life.[7] If MACRS cost recovery is used for income tax purposes, a positive or negative adjustment equal to the difference between MACRS and ADS must be made each year. Finally, no additional first-year depreciation is allowed under the ADS.[8]

Likewise, when assets are disposed of, an additional adjustment to taxable income is required to allow for the difference in gain or loss resulting from the difference in income tax basis and E & P basis.[9] The adjustments arising from depreciation are illustrated in the following example.

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[5] § 312(n)(5).

[6] § 312(k)(3)(A).

[7] See § 168(g)(2). The ADR midpoint life for most assets is set out in Rev.Proc. 87–56, 1987–2 C.B. 674. The recovery period is 5 years for automobiles and light-duty trucks and 40 years for real property. For assets with no class life, the recovery period is 12 years.

[8] § 168(k)(2)(D).

[9] § 312(f)(1).

EXAMPLE 7

On January 2, 2008, White Corporation purchased equipment with an ADR midpoint life of 10 years for $30,000. The equipment was then depreciated over its 7-year MACRS class life. No additional first-year depreciation was claimed. The asset was sold on July 2, 2010, for $27,000. For purposes of determining taxable income and E & P, cost recovery claimed on the equipment is summarized below.

Year	Cost Recovery Computation	MACRS	ADS	Adjustment Amount
2008	$30,000 × 14.29%	$ 4,287		
	$30,000 ÷ 10-year ADR recovery period × ½ (half-year for first year of service)		$1,500	$2,787
2009	$30,000 × 24.49%	7,347		
	$30,000 ÷ 10-year ADR recovery period		3,000	4,347
2010	$30,000 × 17.49% × ½ (half-year for year of disposal)	2,624		
	$30,000 ÷ 10-year ADR recovery period × ½ (half-year for year of disposal)		1,500	1,124
	Total cost recovery	$14,258	$6,000	$8,258

Each year White Corporation increases its taxable income by the adjustment amount indicated above to determine E & P. In addition, when computing E & P for 2010, White reduces taxable income by $8,258 to account for the excess gain recognized for income tax purposes.

	Income Tax	E & P
Amount realized	$ 27,000	$ 27,000
Adjusted basis for income tax ($30,000 cost – $14,258 MACRS)	(15,742)	
Adjusted basis for E & P ($30,000 cost – $6,000 ADS)		(24,000)
Gain on sale	$ 11,258	$ 3,000
Adjustment amount ($3,000 – $11,258)	($ 8,258)	

■

In addition to more conservative depreciation methods, the E & P rules impose limitations on the deductibility of § 179 expense.[10] In particular, this expense is deducted over a period of five years for E & P purposes. Thus, in any year that § 179 is elected, 80 percent of the resulting expense is added back to taxable income to determine current E & P. In each of the following four years, a negative adjustment equal to 20 percent of the § 179 expense is made.

The E & P rules also require specific accounting methods in various situations, making adjustments necessary when different methods are used for income tax purposes. For example, E & P requires cost depletion rather than percentage depletion. When accounting for long-term contracts, E & P rules specify the percentage of completion method rather than the completed contract method. As the E & P determination does not allow for the amortization of organizational expenses, any such expense deducted when computing taxable income must be added back.

To account for income deferral under the LIFO inventory method, the E & P computation requires an adjustment for changes in the LIFO recapture amount (the excess of FIFO over LIFO inventory value) during the year. Increases in LIFO recapture are added to taxable income and decreases are subtracted, to the extent of prior-year increases.

E & P rules also specify that intangible drilling costs and mine exploration and development costs be amortized over a period of 60 months and 120 months, respectively. For income tax purposes, however, these costs can be deducted currently.[11]

[10] § 312(k)(3)(B).

[11] § 312(n).



CONCEPT SUMMARY 10.1

Computing E & P

Transaction	Adjustment to Taxable Income to Determine Current E & P	
	Addition	Subtraction
Tax-exempt income	X	
Dividends received deduction	X	
Collection of proceeds from insurance policy on life of corporate officer (in excess of cash surrender value)	X	
Deferred gain on installment sale (all of the gain is added to E & P in year of sale)	X	
Future recognition of installment sale gross profit		X
Excess capital loss		X
Excess charitable contribution (over 10% limitation) in year incurred		X
Deduction of charitable contribution, NOL, or capital loss carryovers in succeeding taxable years (increase E & P because deduction reduces taxable income while E & P was reduced in a prior year)	X	
Federal income taxes paid		X
Federal income tax refund	X	
Loss on sale between related parties		X
Nondeductible fines, penalties, lobbying costs, meals, and entertainment		X
Payment of premiums on insurance policy on life of corporate officer (in excess of increase in cash surrender value of policy)		X
Realized gain (not recognized) on an involuntary conversion	No effect	
Realized gain or loss (not recognized) on a like-kind exchange	No effect	
Excess percentage depletion (only cost depletion can reduce E & P)	X	
Accelerated depreciation (E & P is reduced only by straight-line, units-of-production, or machine hours depreciation)	X	X
Additional first-year depreciation	X	
Domestic production activities deduction	X	
§ 179 expense in year elected (80%)	X	
§ 179 expense in four years following election (20% each year)		X
Increase (decrease) in LIFO recapture amount	X	X
Intangible drilling costs deducted currently (reduce E & P in future years by amortizing costs over 60 months)	X	
Mine exploration and development costs (reduce E & P in future years by amortizing costs over 120 months)	X	

SUMMARY OF E & P ADJUSTMENTS

E & P serves as a measure of the earnings of the corporation that are available for distribution as taxable dividends to the shareholders. Current E & P is determined by making a series of adjustments to the corporation's taxable income. These adjustments are reviewed in Concept Summary 10.1.

ALLOCATING E & P TO DISTRIBUTIONS

LO.3

Apply the rules for assigning earnings and profits to distributions.

When a positive balance exists in both the current and the accumulated E & P accounts, corporate distributions are deemed to be made first from current E & P and then from accumulated E & P. When distributions exceed the amount of current E & P, it becomes necessary to allocate current and accumulated E & P to each distribution made during the year. First, dollars of current E & P are applied on a pro rata basis to each distribution. Then, accumulated E & P is applied in chronological order, beginning with the earliest distribution. This allocation is important if any shareholder sells stock during the year.

TAX in the NEWS

The Bailout Paid Big Dividends

In October 2008, nine American banks received $125 billion from the Federal government in exchange for shares of preferred stock—to shore up their finances in the form of a "bailout." At the time of the bailout, some pointed out that the agreement did not impose any restrictions on dividends paid by the banks receiving the bailout money. Estimates were that any such dividends would redirect more than 20 percent of the Federal money to shareholders of the banks in 2009 alone. Since the money would be distributed to shareholders, it would not be available to improve the banks' financial position—ostensibly, the purpose of the bailout. Interestingly, a finance professor at Harvard estimated that the officers and directors of the nine banks involved would receive about $250 million of the bailout cash in dividend payments in the first year as a result of the shares they owned in the banks.

Management at these banks argued that dividend payments were necessary to support stock prices and make the raising of additional capital possible. While shareholders of healthy companies should be indifferent to dividend payments (from an economic perspective), at distressed companies (e.g., banks) dividends favor the interests of shareholders over lenders. Each dollar paid out as a dividend is not available to creditors in a bankruptcy proceeding. Thus, the dividend payments represent "an attempt by shareholders to beat creditors out the door."

During 2009, some banks responded to government and public pressure and reduced or eliminated their dividend payouts. Not all banks reduced their dividends, however. As of early 2009, a number of banks continued to pay out significant amounts. Wells Fargo, which took $25 billion in bailout funds, maintained its dividend payouts until March 2009. PNC Financial Services Group, U.S. Bancorp, Capital One Financial, the Goldman Sachs Group, and Morgan Stanley also continued to pay significant dividends to shareholders.

Source: Adapted from David Scharfstein and Jeremy C. Stein, "This Bailout Doesn't Pay Dividends," *New York Times*, October 20, 2008.

EXAMPLE 8

On January 1 of the current year, Black Corporation has accumulated E & P of $10,000. Current E & P for the year amounts to $30,000. Megan and Matt are sole *equal* shareholders of Black from January 1 to July 31. On August 1, Megan sells all of her stock to Helen. Black makes two distributions to shareholders during the year: $40,000 to Megan and Matt ($20,000 to each) on July 1, and $40,000 to Matt and Helen ($20,000 to each) on December 1. Current and accumulated E & P are applied to the two distributions as follows.

	Source of Distribution		
	Current E & P	Accumulated E & P	Return of Capital
July 1 distribution ($40,000)	$15,000	$10,000	$15,000
December 1 distribution ($40,000)	15,000	–0–	25,000

Since 50% of the total distributions are made on July 1 and December 1, respectively, one-half of current E & P is assigned to the two distributions. Accumulated E & P is applied in chronological order, so the entire amount attaches to the July 1 distribution. The tax consequences to the shareholders are presented below.

	Shareholder		
	Megan	Matt	Helen
July distribution ($40,000)			
Dividend income—			
From current E & P ($15,000)	$ 7,500	$ 7,500	$ –0–
From accumulated E & P ($10,000)	5,000	5,000	–0–
Return of capital ($15,000)	7,500*	7,500	–0–
December distribution ($40,000)			
Dividend income—			
From current E & P ($15,000)	–0–	7,500	7,500
From accumulated E & P ($0)	–0–	–0–	–0–
Return of capital ($25,000)	–0–	12,500	12,500



BRIDGE TO FINANCE

Investors often have tried to read the dividend policies of a corporation as indicators of the strength of the entity: Constant dividend payments indicated a stable financial structure for the corporation, while dividend increases were a predictor of good times and triggered stock price increases. Reductions in historic dividend payment patterns foreshadowed financial difficulties and often caused a quick and sizable drop in share price.

Nobel Prize winners Merton Miller, University of Chicago, and Franco Modigliani, MIT, saw things differently. They viewed dividends as a remnant of various financing sources available to the corporation: If it was cheaper to finance future growth by retaining profits and decreasing or eliminating dividend payments, so be it. The entity must reduce its cost of capital wherever possible, and, under this interpretation, a dividend decrease might indicate the internal financial strength of the corporation. Conversely, the payment of a dividend reduces the capital available to the entity, thereby forcing the entity to finance its operations and growth from some third-party source and risking future weakness if the cost of that capital increases.

Miller and Modigliani held that stock price and dividend policy were unrelated, and that changes in dividend patterns should not affect the capitalized value of the business. Their original studies are more than 40 years old, but the market seems to have adopted them. Even with lower tax rates on dividends, few shareholders complain that the typical growth stock never pays dividends. Nevertheless, shares of companies that pay dividends outperform those that don't pay dividends.

	Shareholder		
	Megan	**Matt**	**Helen**
Total dividend income	$12,500	$20,000	$ 7,500
Nontaxable return of capital (assuming sufficient basis in the stock investment)	$ 7,500	$20,000	$12,500

Because the balance in the accumulated E & P account is exhausted when it is applied to the July 1 distribution, Megan has more dividend income than Helen, even though both receive equal distributions during the year. In addition, each shareholder's basis is reduced by the nontaxable return of capital; any excess over basis results in taxable gain. ■

When the tax years of the corporation and its shareholders are not the same, it may be impossible to determine the amount of current E & P on a timely basis. For example, if shareholders use a calendar year and the corporation uses a fiscal year, then current E & P may not be ascertainable until after the shareholders' tax returns have been filed. To address this timing issue, the allocation rules presume that current E & P is sufficient to cover every distribution made during the year until the parties can show otherwise.

EXAMPLE 7

Green Corporation uses the fiscal year of July 1 through June 30 for tax purposes. Carol, Green's only shareholder, uses a calendar year. On July 1, 2010, Green Corporation has a zero balance in its accumulated E & P account. For fiscal year 2010–2011, the corporation incurs a $5,000 deficit in current E & P. On August 1, 2010, Green distributed $10,000 to Carol. The distribution is dividend income to Carol and is reported when she files her income tax return for the 2010 calendar year, on or before April 15, 2011.

Because Carol cannot prove until June 30, 2011, that the corporation has a deficit for the 2010–2011 fiscal year, she must assume the $10,000 distribution is fully covered by current E & P. When Carol learns of the deficit, she can file an amended return for 2010 showing the $10,000 as a return of capital. Alternatively, Carol can file for an extension for her returns, while she awaits Green Corporation's fiscal year-end. ■

Additional difficulties arise when either the current or the accumulated E & P account has a deficit balance. In particular, when current E & P is positive and accumulated E & P has a deficit balance, accumulated E & P is *not* netted against current E & P. Instead, the distribution is deemed to be a taxable dividend to the extent of the positive current E & P balance.



CONCEPT SUMMARY 10.2

Allocating E & P to Distributions

1. Current E & P is applied first to distributions on a pro rata basis; then, accumulated E & P is applied (as necessary) in chronological order beginning with the earliest distribution. See Example 8.
2. Until the parties can show otherwise, it is presumed that current E & P covers all distributions. See Example 9.
3. When a deficit exists in accumulated E & P and a positive balance exists in current E & P, distributions are regarded as dividends to the extent of current E & P. See Example 10.
4. When a deficit exists in current E & P and a positive balance exists in accumulated E & P, the two accounts are netted at the date of distribution. If the resulting balance is zero or a deficit, the distribution is treated as a return of capital, first reducing the basis of the stock to zero, then generating taxable gain. If a positive balance results, the distribution is a dividend to the extent of the balance. Any loss in current E & P is deemed to accrue ratably throughout the year unless the corporation can show otherwise. See Example 11.

EXAMPLE 10

At the beginning of the current year, Brown Corporation has a deficit of $30,000 in accumulated E & P. For the year, it has current E & P of $10,000 and distributes $5,000 to its shareholders. The $5,000 distribution is treated as a taxable dividend since it is deemed to have been made from current E & P. This is the case even though Brown Corporation still has a deficit in accumulated E & P at the end of the year. ■

In contrast to the previous rule, when a deficit exists in current E & P and a positive balance exists in accumulated E & P, the accounts are netted at the date of distribution. If the resulting balance is zero or negative, the distribution is a return of capital. If a positive balance results, the distribution is a dividend to the extent of the balance. Any loss in current E & P is deemed to accrue ratably throughout the year unless the parties can show otherwise.

EXAMPLE 11

At the beginning of the current year, Gray Corporation (a calendar year taxpayer) has accumulated E & P of $10,000. During the year, the corporation incurs a $15,000 deficit in current E & P that accrues ratably. On July 1, Gray Corporation distributes $6,000 in cash to Hal, its sole shareholder. To determine how much of the $6,000 cash distribution represents dividend income to Hal, the balances of both accumulated and current E & P as of July 1 are determined and netted. This is necessary because of the deficit in current E & P.

	Source of Distribution	
	Current E & P	Accumulated E & P
January 1		$10,000
July 1 (½ of $15,000 deficit in current E & P)	($7,500)	2,500
July 1 distribution of $6,000:		
Dividend income: $2,500		
Return of capital: $3,500		

The balance in E & P just before the July 1 distribution is $2,500. Thus, of the $6,000 distribution, $2,500 is taxed as a dividend, and $3,500 represents a return of capital. ■

Tax Planning Strategies CORPORATE DISTRIBUTIONS

FRAMEWORK FOCUS: INCOME AND EXCLUSIONS

Strategy: Avoid Income Recognition.

In connection with the discussion of corporate distributions, the following points need reinforcement.

- Because E & P is the measure of dividend income, its periodic determination is essential to corporate planning. Thus, an E & P account should be established and maintained, particularly if the possibility exists that a corporate distribution might be a return of capital.
- Accumulated E & P is the sum of all past years' current E & P. Because there is no statute of limitations on the computation of E & P, the IRS can redetermine a corporation's current E & P for a tax year long since passed. Such a change affects accumulated E & P and has a direct impact on the taxability of current distributions to shareholders.
- Distributions can be planned to avoid or minimize dividend exposure.

EXAMPLE 12

Flicker Corporation has accumulated E & P of $100,000 as of January 1 of the current year. During the year, it expects to generate earnings from operations of $80,000 and to sell an asset for a loss of $100,000. Thus, it anticipates a current E & P deficit of $20,000. Flicker also expects to make a cash distribution of $60,000.

A tax-effective approach is to recognize the loss as soon as possible and immediately thereafter make the cash distribution to the shareholders. Suppose these two steps take place on January 1. Because the current E & P has a deficit, the accumulated E & P account must be brought up to date (refer to Example 11). Thus, at the time of the distribution, the combined E & P balance is zero [$100,000 (beginning balance in accumulated E & P) – $100,000 (existing deficit in current E & P)], and the $60,000 distribution to the shareholders constitutes a return of capital. Current deficits are deemed to accrue pro rata throughout the year unless the parties can prove otherwise. Here they can. ■

EXAMPLE 13

After several unprofitable years, Darter Corporation has a deficit in accumulated E & P of $100,000 as of January 1, 2010. Starting in 2010, Darter expects to generate annual E & P of $50,000 for the next four years and would like to distribute this amount to its shareholders. The corporation's cash position (for dividend purposes) will correspond to the current E & P generated. Compare the following possibilities.

1. On December 31 of 2010, 2011, 2012, and 2013, Darter Corporation distributes cash of $50,000.
2. On December 31 of 2011 and 2013, Darter Corporation distributes cash of $100,000.

The two alternatives are illustrated as follows.

Year	Accumulated E & P (First of Year)	Current E & P	Distribution	Amount of Dividend
		Alternative 1		
2010	($ 100,000)	$50,000	$ 50,000	$50,000
2011	(100,000)	50,000	50,000	50,000
2012	(100,000)	50,000	50,000	50,000
2013	(100,000)	50,000	50,000	50,000
		Alternative 2		
2010	($ 100,000)	$50,000	$ –0–	$ –0–
2011	(50,000)	50,000	100,000	50,000
2012	(50,000)	50,000	–0–	–0–
2013	–0–	50,000	100,000	50,000

Alternative 1 produces $200,000 of dividend income because each $50,000 distribution is fully paid from current E & P. Alternative 2, however, produces only $100,000 of dividend income to the shareholders. The remaining $100,000 is a return of capital. Why? At the time Darter Corporation made its first distribution of $100,000 on December 31, 2011, it had a deficit of $50,000 in accumulated E & P (the original deficit of $100,000 is reduced by the $50,000 of current E & P from 2010). Consequently, the $100,000 distribution yields a $50,000 dividend (the current E & P for 2011), and $50,000 is treated as a return of capital. As of January 1, 2012, Darter's accumulated E & P now has a deficit balance of $50,000, since a distribution cannot increase a deficit in E & P. Adding the remaining $50,000 of current E & P from 2012, the balance as of January 1, 2013, is zero. Thus, the second distribution of $100,000 made on December 31, 2013, also yields $50,000 of dividends (the current E & P for 2013) and a $50,000 return of capital. ■



Bridge to Investments

Most investors look to the stocks of utilities, real estate investment trusts, and tobacco companies as the source of steady dividend payments. This is a prudent decision on the investor's part, as the typical S&P 500 stock offers a dividend yield of just over 1 percent. But an investor could put together an effective portfolio using only stocks and mutual funds that regularly produce dividend yields of at least 2 percent.

Dividends can be important to the investor because:

- They can be used in a tax-sheltered account, like a § 401(k) plan, such that the tax inefficiency of the dividends is not recognized immediately by the investor.
- Even today, about 40 percent of the total return from an investment can be traced to holding stocks that make regular distributions.
- Generally, a dividend-paying company is a profitable company, and corporate profits often are hard to come by.
- Earning and reinvesting dividends is an easy way to put into place an investment policy of dollar-cost averaging, a technique that forces the investor to buy more shares when prices are low and fewer shares when prices are high. Dollar-cost averaging often implements a contrarian investment strategy.

10.3 Property Dividends

LO.4

Understand the tax effects of property dividends on the recipient shareholder and the corporation making the distribution.

The previous discussion assumed that all distributions by a corporation to its shareholders are in the form of cash. Although most corporate distributions are paid in cash, a corporation may distribute a **property dividend** for various reasons. The shareholders may want a particular property that is held by the corporation. Or a corporation that is strapped for cash may want to distribute a dividend to its shareholders.

Property distributions have the same tax impact as distributions of cash except for effects attributable to any difference between the basis and the fair market value of the distributed property. In most situations, distributed property is appreciated, so its sale would result in a gain to the corporation. Distributions of property with a basis that differs from fair market value raise several tax questions.

- For the shareholder:
  - What is the amount of the distribution?
  - What is the basis of the property in the shareholder's hands?
- For the corporation:
  - Is a gain or loss recognized as a result of the distribution?
  - What is the effect of the distribution on E & P?

PROPERTY DIVIDENDS—EFFECT ON THE SHAREHOLDER

When a corporation distributes property rather than cash to a shareholder, the amount distributed is measured by the fair market value of the property on the date of distribution.[12] As with a cash distribution, the portion of a property distribution covered by existing E & P is a dividend, and any excess is treated as a return of capital. If the fair market value of the property distributed exceeds the corporation's E & P and the shareholder's basis in the stock investment, a capital gain usually results.

The amount distributed is reduced by any liabilities to which the distributed property is subject immediately before and immediately after the distribution and by any

[12] § 301.

TAX in the NEWS

Credit Crunch Triggers Record Dividend Cuts

Because many investors rely on certain stocks to yield dividends, it is rare to cut or eliminate such dividends. In 2008 and 2009, however, the credit crunch resulted in a record number of corporations reducing or omitting dividend payments. In 2008, 218 publicly traded companies cut their dividends, resulting in $40.6 billion in lost dividend income to investors. This represented a 15-fold increase over the number of dividend cuts in 2007. The previous record, set in 1931 during the Great Depression, saw only 141 publicly traded companies reduce dividend payments.

In 2008, businesses in the financial services sector accounted for the largest share of the dividend cuts. Although a traditionally reliable source of dividend income, these companies held on to their money to shore up balance sheets battered by losses from mortgage-related securities.

liabilities of the corporation assumed by the shareholder. The basis in the distributed property to the shareholder is the fair market value of the property on the date of the distribution.

EXAMPLE 14

Robin Corporation has E & P of $60,000. It distributes land with a fair market value of $50,000 (adjusted basis of $30,000) to its sole shareholder, Charles. The land is subject to a liability of $10,000, which Charles assumes. Charles has a taxable dividend of $40,000 [$50,000 (fair market value) − $10,000 (liability)]. The basis of the land to Charles is $50,000. ■

EXAMPLE 15

Red Corporation owns 10% of Tan Corporation. Tan has ample E & P to cover any distributions made during the year. One distribution made to Red consists of a vacant lot with a basis of $50,000 and a fair market value of $30,000. Red recognizes a taxable dividend of $30,000, and its basis in the lot becomes $30,000. ■

Distributing property that has depreciated in value as a property dividend may reflect poor planning. Note what happens in Example 15. Basis of $20,000 disappears due to the loss (basis $50,000, fair market value $30,000). As an alternative, if Tan Corporation sells the lot, it could use the loss to reduce its taxes. Then Tan could distribute the $30,000 of proceeds to its shareholders.

PROPERTY DIVIDENDS—EFFECT ON THE CORPORATION

As noted earlier, the distribution of a property dividend raises two questions related to the corporation's tax position: Is a gain or loss recognized? What is the effect on E & P?

Recognition of Gain or Loss

All distributions of appreciated property generate gain to the distributing corporation.[13] In effect, a corporation that distributes appreciated property is treated as if it had sold the property to the shareholder for its fair market value. However, the distributing corporation does *not* recognize loss on distributions of property.

EXAMPLE 16

A corporation distributes land (basis of $10,000 and fair market value of $30,000) to a shareholder. The corporation recognizes a gain of $20,000. ■

[13] § 311.



Bridge to Finance

The double tax on corporate income has always been controversial. Reformers have argued that taxing corporate profits twice creates several distortions in the economy, including:

- An incentive to invest in noncorporate rather than corporate businesses.
- An incentive for corporations to finance operations with debt rather than new equity because interest payments are deductible.
- An incentive for corporations to retain earnings and to structure distributions of profits to avoid the double tax.

Taken together, these distortions raise the cost of capital for corporate investments and increase the vulnerability of corporations in economic downturns due to excessive debt financing. Reformers argue that eliminating the double tax would remove these distortions, stimulate the economy (with estimated gains of up to $25 billion annually), and increase the value of capital stock in the corporate sector by as much as $500 billion. They also argue that elimination of the double tax would make the United States more competitive internationally, because the majority of our trading partners assess only one tax on corporate income.

In contrast, supporters of the double tax argue that in view of the economic power held by publicly traded corporations, the tax is appropriate, especially since the income tax is based on notions of ability to pay and fairness. They also argue that many of the distortions can already be avoided through the use of deductible payments by closely held C corporations and through partnerships, limited liability companies, and S corporations.

EXAMPLE 17

Assume the property in Example 16 has a basis of $30,000 and a fair market value of $10,000. The corporation does not recognize a loss on the distribution. ■

If the distributed property is subject to a liability in excess of basis or the shareholder assumes such a liability, a special rule applies. For purposes of determining gain on the distribution, the fair market value of the property is treated as not being less than the amount of the liability.[14]

EXAMPLE 18

Assume the land in Example 16 is subject to a liability of $35,000. The corporation recognizes gain of $25,000 on the distribution ($35,000 − $10,000). ■

Effect of Corporate Distributions on E & P

Corporate distributions reduce E & P by the amount of money distributed and by the greater of the fair market value or the adjusted basis of property distributed, less the amount of any liability on the property.[15] E & P is increased by gain recognized on appreciated property distributed as a property dividend.

EXAMPLE 19

Crimson Corporation distributes property (basis of $10,000 and fair market value of $20,000) to Brenda, its shareholder. Crimson Corporation recognizes a gain of $10,000, which is added to its E & P. E & P then is reduced by $20,000, the fair market value of the property. Brenda has dividend income of $20,000 (presuming sufficient E & P). ■

EXAMPLE 20

Assume the same facts as in Example 19, except that the property's adjusted basis in the hands of Crimson Corporation is $25,000. Because a loss is not recognized and the property's adjusted basis is greater than its fair market value, E & P is reduced by $25,000. Brenda reports dividend income of $20,000 (the fair market value of the property received). ■

[14] § 311(b)(2).

[15] §§ 312(a), (b), and (c).

EXAMPLE 21

Assume the same facts as in Example 20, except that the property is subject to a liability of $6,000. E & P is now reduced by $19,000 [$25,000 (adjusted basis) – $6,000 (liability)]. Brenda has a dividend of $14,000 [$20,000 (amount of the distribution) – $6,000 (liability)], and her basis in the property is $20,000. ■

Under no circumstances can a distribution, whether cash or property, either generate a deficit in E & P or add to a deficit in E & P. Deficits can arise only through recognized corporate losses.

EXAMPLE 22

Teal Corporation has accumulated E & P of $10,000 at the beginning of the current tax year. During the year, it has current E & P of $15,000. At the end of the year, it distributes cash of $30,000 to its sole shareholder, Walter. Teal's E & P at the end of the year is zero. The accumulated E & P of $10,000 is increased by current E & P of $15,000 and reduced $25,000 by the dividend distribution. The remaining $5,000 of the distribution to Walter does not reduce E & P because a distribution cannot generate a deficit in E & P. ■

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.



10.4 Constructive Dividends

LO.5

Understand the nature and treatment of constructive dividends.

Any measurable economic benefit conveyed by a corporation to its shareholders can be treated as a dividend for Federal income tax purposes even though it is not formally declared or designated as a dividend. A distribution need not be issued pro rata to all shareholders.[16] Nor must the distribution satisfy the legal requirements of a dividend as set forth by applicable state law. This benefit, often described as a **constructive dividend**, is distinguishable from actual corporate distributions of cash and property in form only.

Constructive dividend situations usually arise in the context of closely held corporations. Here, the dealings between the parties are less structured, and frequently, formalities are not preserved. The constructive dividend serves as a substitute for actual distributions. Usually, it is intended to accomplish some tax objective not available through the use of direct dividends. The shareholders may be attempting to distribute corporate profits in a form deductible to the corporation, like compensation. Alternatively, the shareholders may be seeking benefits for themselves while avoiding the recognition of income. Some constructive dividends are, in reality, disguised dividends. But not all constructive dividends are deliberate attempts to avoid actual and formal dividends; many are inadvertent. Thus, an awareness of the various constructive dividend situations is essential to protect the parties from unanticipated, undesirable tax consequences.

TYPES OF CONSTRUCTIVE DIVIDENDS

The most frequently encountered types of constructive dividends are summarized on the following pages.

Shareholder Use of Corporate-Owned Property

A constructive dividend can occur when a shareholder uses the corporation's property for personal purposes at no cost. Personal use of corporate-owned automobiles, airplanes, yachts, fishing camps, hunting lodges, and other entertainment facilities is commonplace in some closely held corporations. The shareholder has dividend

[16]See *Lengsfield v. Comm.*, 57–1 USTC ¶9437, 50 AFTR 1683, 241 F.2d 508 (CA–5, 1957).

income to the extent of the fair rental value of the property for the period of its personal use.[17]

Bargain Sale of Corporate Property to a Shareholder

Shareholders often purchase property from a corporation at a cost below the fair market value of the property. These bargain sales produce dividend income to the extent that the property's fair market value on the date of sale differs from the amount the shareholder paid for the property.[18] These situations might be avoided by appraising the property on or about the date of the sale. The appraised value should become the price to be paid by the shareholder.

Bargain Rental of Corporate Property

A bargain rental of corporate property by a shareholder also produces dividend income. Here the measure of the constructive dividend is the excess of the property's fair rental value over the rent actually paid. Again, appraisal data should be used to avoid any questionable situations.

Payments for the Benefit of a Shareholder

If a corporation pays an obligation of a shareholder, the payment is treated as a constructive dividend. The obligation involved need not be legally binding on the shareholder; it may, in fact, be a moral obligation.[19] Forgiveness of shareholder indebtedness by the corporation creates an identical problem.[20] Excessive rentals paid by a corporation for the use of shareholder property also are treated as constructive dividends.

Unreasonable Compensation

A salary payment to a shareholder-employee that is deemed to be **unreasonable compensation** is frequently treated as a constructive dividend. As a consequence, it is not deductible by the corporation. In determining the reasonableness of salary payments, the following factors are considered.

- The employee's qualifications.
- A comparison of salaries with dividend distributions.
- The prevailing rates of compensation for comparable positions in comparable business concerns.
- The nature and scope of the employee's work.
- The size and complexity of the business.
- A comparison of salaries paid with both gross and net income.
- The taxpayer's salary policy toward all employees.
- For small corporations with a limited number of officers, the amount of compensation paid to the employee in question in previous years.
- For large corporations, whether a "reasonable investor" would have agreed to the level of compensation paid.[21]

Loans to Shareholders

Advances to shareholders that are not bona fide loans are constructive dividends. Whether an advance qualifies as a bona fide loan is a question of fact to be determined in light of the particular circumstances. Factors considered in determining whether the advance is a bona fide loan include the following.[22]

[17] *Daniel L. Reeves*, 94 TCM 287, T.C.Memo. 2007–273.

[18] Reg. § 1.301–1(j).

[19] *Montgomery Engineering Co. v. U.S.*, 64–2 USTC ¶9618, 13 AFTR 2d 1747, 230 F.Supp. 838 (D.Ct. N.J., 1964), *aff'd* in 65–1 USTC ¶9368, 15 AFTR 2d 746, 344 F.2d 996 (CA–3, 1965).

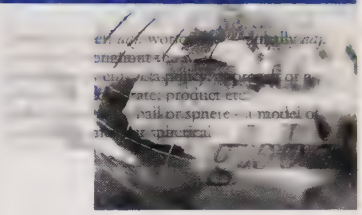
[20] Reg. § 1.301–1(m).

[21] *Mayson Manufacturing Co. v. Comm.*, 49–2 USTC ¶9467, 38 AFTR 1028, 178 F.2d 115 (CA–6, 1949) and *Alpha Medical v. Comm.*, 99–1 USTC ¶50,461, 83 AFTR 2d 99–697, 172 F.3d 942 (CA–6, 1999).

[22] *Fin Hay Realty Co. v. U.S.*, 68–2 USTC ¶9438, 22 AFTR 2d 5004, 398 F.2d 694 (CA–3, 1968).

A Worldwide View of Dividends

GLOBAL
Tax Issues



From an international perspective, the United States' double taxation of dividends is unusual. Most developed countries have adopted a policy of corporate integration, which imposes a single tax on corporate profits. Corporate integration takes several forms. One popular approach is to impose a tax at the corporate level, but allow shareholders to claim a credit for corporate-level taxes paid when dividends are received. A second alternative is to allow a corporate-level deduction for dividends paid to shareholders. A third approach is to allow shareholders to exclude corporate dividends from income. A fourth alternative is the adoption of a "comprehensive business income tax," which excludes both dividend and interest income while disallowing deductions for interest expense.

Facing trade-offs between equity and the economic distortions introduced by the double tax and the prevalence of corporate integration throughout the world, the United States continues to struggle with the issue of how corporate distributions should be taxed.

- Whether the advance is on open account or is evidenced by a written instrument.
- Whether the shareholder furnished collateral or other security for the advance.
- How long the advance has been outstanding.
- Whether any repayments have been made.
- The shareholder's ability to repay the advance.
- The shareholder's use of the funds (e.g., payment of routine bills versus nonrecurring, extraordinary expenses).
- The regularity of the advances.
- The dividend-paying history of the corporation.

Even when a corporation makes a bona fide loan to a shareholder, a constructive dividend may be triggered, equal to the amount of any imputed (forgone) interest on the loan.[23] Imputed interest equals the amount of interest (using the rate the Federal government pays on new borrowings, compounded semiannually) that exceeds the interest charged on the loan. When the imputed interest provision applies, the shareholder is deemed to have made an interest payment to the corporation equal to the amount of imputed interest, and the corporation is deemed to have repaid the imputed interest to the shareholder through a constructive dividend. As a result, the corporation receives interest income and makes a nondeductible dividend payment, and the shareholder has taxable dividend income that might be offset with an interest deduction.

EXAMPLE 23

Mallard Corporation lends its principal shareholder, Henry, $100,000 on January 2 of the current year. The loan is interest-free and payable on demand. On December 31, the imputed interest rules are applied. Assuming the Federal rate is 6%, compounded semiannually, the amount of imputed interest is $6,090. This amount is deemed paid by Henry to Mallard in the form of interest. Mallard is then deemed to return the amount to Henry as a constructive dividend. Thus, Henry has dividend income of $6,090, which might be offset with a deduction for the interest deemed paid to Mallard. Mallard has interest income of $6,090 for the interest received, with no offsetting deduction for the dividend payment. ■

[23]See § 7872. A more detailed discussion of imputed interest is found in Chapter 4.

TAX in the NEWS

Hard Work Pays Off!

By 1985, William Rogers, a pharmacist with 25 years of experience in health care, had successfully developed and sold two businesses—a pharmacy chain and a medical supply company. In 1986, after turning down a $1 million offer to manage the home health care division of a large corporation, Rogers founded Alpha Medical, Inc., with a $1,000 contribution. Over the next four years, Rogers built Alpha Medical into a business with 60 employees, a taxable income of almost $7 million, and a 1990 return on equity of almost 100 percent. The business provided both financial management and medical consulting services to hospitals and home health care companies. Rogers was the company's sole shareholder and president. He regularly worked 12 hours a day and was on call 24 hours a day. Rogers made all major decisions for Alpha Medical, acquired all of the company's clients, and personally negotiated all of the company's contracts. In addition, he personally developed many of the company's products and collaborated with programmers to develop proprietary software used by the company.

In 1986, Rogers received only $67,000 in compensation. The amount increased to $431,000 in 1988 and $928,000 in 1989. In 1990, Rogers was paid over $4.4 million, 64 percent of the company's taxable income, while the company paid only a $1,500 dividend.

During an audit of Alpha Medical, the IRS argued that only $400,000 of Rogers' compensation in 1990 was reasonable and that the remaining $4 million was not deductible. As a result, the IRS assessed a $1.3 million tax deficiency and an accuracy-related penalty.

The Tax Court split the difference between the IRS and the taxpayer, holding that $2.3 million of Rogers' pay was reasonable. On appeal, however, the Sixth Circuit Court of Appeals ruled that all $4.4 million of the compensation paid to Rogers was reasonable. In its decision, the Court of Appeals said that "in light of Rogers' record of accomplishment, risks he assumed, and amazing growth, reasonable shareholders would have gladly agreed to Rogers' level of compensation." The Court of Appeals also explicitly noted that Rogers had been undercompensated in prior years and that he had incurred a substantial opportunity cost when he refused the $1 million job offer so that he could start Alpha Medical.

Loans to a Corporation by Shareholders

Shareholder loans to a corporation may be reclassified as equity if the debt has too many features of stock. Any interest and principal payments made by the corporation to the shareholder are then treated as constructive dividends. This topic was covered more thoroughly in the discussion of "thin capitalization" in Chapter 9.

TAX TREATMENT OF CONSTRUCTIVE DIVIDENDS

For tax purposes, constructive distributions are treated the same as actual distributions.[24] Thus, a corporate shareholder is entitled to the dividends received deduction (refer to Chapter 9). The constructive distribution is taxable as a dividend only to the extent of the corporation's current and accumulated E & P. The burden rests with the taxpayer to prove that the distribution constitutes a return of capital because of inadequate E & P.[25]

DIGGING DEEPER 2

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

[24] *Simon v. Comm.*, 57–2 USTC ¶9989, 52 AFTR 698, 248 F.2d 869 (CA–8, 1957).

[25] *DiZenzo v. Comm.*, 65–2 USTC ¶9518, 16 AFTR 2d 5107, 348 F.2d 122 (CA–2, 1965).

TAX

Dividend Payments React to Tax Law Changes

Recurring dividend payments are rare, but U.S. C corporations can pay dividends when they want to. When the tax law allowed a one-time exclusion for 85 percent of dividends repatriated from overseas subsidiaries, suddenly large corporate taxpayers responded. About 1,000 U.S. C corporations increased their dividend payments for the year by more than $300 billion over their average annual payments to shareholders. If Congress needs to counteract its budget deficits in the future, this tax provision represents a good clue as to how to do it. Large entities have accumulated huge amounts of cash internally, and all it takes is a tax break to free up those dollars for the rest of the economy.

Tax Planning Strategies Constructive Dividends

FRAMEWORK FOCUS: INCOME AND EXCLUSIONS

Strategy: Avoid Income Recognition.

Tax planning can be particularly effective in avoiding constructive dividend situations. Shareholders should try to structure their dealings with the corporation on an arm's length basis. For example, reasonable rent should be paid for the use of corporate property, and a fair price should be paid for its purchase. The parties should make every effort to support the amount involved with appraisal data or market information obtained from reliable sources at or near the time of the transaction. Dealings between shareholders and a closely held corporation should be as formal as possible. In the case of loans to shareholders, for example, the parties should provide for an adequate rate of interest and written evidence of the debt. Shareholders also should establish and follow a realistic repayment schedule.

If shareholders wish to distribute corporate profits in a form deductible to the corporation, a balanced mix of the possible alternatives lessens the risk of constructive dividend treatment. Rent for the use of shareholder property, interest on amounts borrowed from shareholders, or salaries for services rendered by shareholders are all feasible substitutes for dividend distributions. But overdoing any one approach may attract the attention of the IRS. Too much interest, for example, may mean the corporation is thinly capitalized, and some of the debt may be reclassified as equity.

Much can be done to protect against the disallowance of unreasonable compensation. Example 24 is an illustration, all too common in a family corporation, of what *not* to do.

EXAMPLE 24

Bob Cole wholly owns Eagle Corporation. Corporate employees and annual salaries include Mrs. Cole ($120,000), Cole, Jr. ($80,000), Bob Cole ($640,000), and Ed ($320,000). The operation of Eagle Corporation is shared about equally between Bob Cole and Ed, who is an unrelated party. Mrs. Cole performed significant services for Eagle during its formative years but now merely attends the annual meeting of the board of directors. Cole, Jr., Bob Cole's son, is a full-time student and occasionally signs papers for the corporation in his capacity as treasurer. Eagle Corporation has not distributed a dividend for 10 years, although it has accumulated substantial E & P. Mrs. Cole, Cole, Jr., and Bob Cole run the risk of a finding of unreasonable compensation, based on the following factors.

- Mrs. Cole's salary is vulnerable unless proof is available that some or all of her $120,000 annual salary is payment for services rendered to the corporation in prior years and that she was underpaid for those years.[26]
- Cole, Jr.'s salary also is vulnerable; he does not appear to earn the $80,000 paid to him by the corporation. Although neither Cole, Jr., nor Mrs. Cole is a shareholder, each one's relationship to Bob Cole is enough of a tie-in to raise the unreasonable compensation issue.

[26]See, for example, *R. J. Nicoll Co.*, 59 T.C. 37 (1972).

- Bob Cole's salary appears susceptible to challenge. Why is he receiving $320,000 more than Ed when it appears that they share equally in the operation of the corporation?
- The fact that Eagle Corporation has not distributed dividends over the past 10 years, even though it is capable of doing so, increases the likelihood of a constructive dividend. ■

What could have been done to improve the tax position of the parties in Example 24? Mrs. Cole and Cole, Jr., are not entitled to a salary as neither seems to be performing any services for the corporation. Paying them a salary simply aggravates the problem. The IRS is more apt to consider *all* the salaries to members of the family as being excessive under the circumstances. Bob Cole probably should reduce his compensation to correspond to that paid to Ed. He then can attempt to distribute corporate earnings to himself in some other form.

Paying some dividends to Bob Cole would also help alleviate the problems raised in Example 24. The IRS has been successful in denying a deduction for salary paid to a shareholder-employee, even when the payment was reasonable, in a situation where the corporation had not distributed any dividends.[27] Most courts, however, have not denied deductions for compensation solely because a dividend was not paid. A better approach is to compare an employee's compensation with the level of compensation prevalent in the particular industry.

The corporation can substitute *indirect* compensation for Bob Cole by paying expenses that benefit him personally but are nevertheless deductible to the corporation. For example, premiums paid by the corporation for sickness, accident, and hospitalization insurance for Bob Cole are deductible to the corporation and generally nontaxable to him.[28] Any payments under the policy are not taxable to Bob Cole unless they exceed his medical expenses.[29] The corporation also can pay for travel and entertainment expenses incurred by Cole on behalf of the corporation. If these expenditures are primarily for the benefit of the corporation, Bob Cole recognizes no taxable income and the corporation claims a deduction.[30] The tax treatment of these benefits is discussed in more detail in Chapter 17.

When testing for reasonableness, the IRS looks at the total compensation package, including indirect compensation payments to a shareholder-employee. Thus, indirect payments must not be overlooked.

Cora, the president and sole shareholder of Willet Corporation, is paid an annual salary of $100,000 by the corporation. Cora would like to draw funds from the corporation but is concerned that additional salary payments might cause the IRS to contend her salary is unreasonable. Cora does not want Willet to pay any dividends. She also wishes to donate $50,000 to her alma mater to establish scholarships for needy students. Willet Corporation could make the contribution on Cora's behalf. The payment clearly benefits Cora, but the amount of the contribution is not taxed to her.[31] Willet claims a charitable contribution deduction for the payment. ■

Assume in Example 25 that Cora has made an individual pledge to the university to provide $50,000 for scholarships for needy students. Willet Corporation satisfies Cora's pledge by paying the $50,000 to the university. The $50,000 will be taxed to Cora. In this context, the $50,000 payment to the university may be treated as *indirect* compensation to Cora.[32] In determining whether Cora's salary is unreasonable, both the *direct* payment of $100,000 and the *indirect* $50,000 payment are considered. Cora's total compensation package is $150,000. Cora may be eligible for a charitable contribution deduction, up to 50% of her adjusted gross income. However, the partial phaseout of itemized deductions for high-income individuals may limit the deduction (see Chapter 16). ■

10.5 Stock Dividends

LO.6
Distinguish between taxable and nontaxable stock dividends.

On occasion, a C corporation issues a dividend in the form of its own stock (i.e., instead of using cash or other property). This may occur because the entity is short of cash, or because it wants to dispose of some treasury stock that it holds. A **stock dividend** is triggered by a board directive. Stock dividends are rare events; less than 1 percent of all C corporation distributions during a typical tax year involve the corporation's own shares.

[27] *McCandless Tile Service v. U.S.*, 70–1 USTC ¶9284, 25 AFTR 2d 70–870, 422 F.2d 1336 (Ct.Cls., 1970). The court in *McCandless* concluded that a return on equity of 15% of net profits was reasonable.

[28] Reg. § 1.162–10.

[29] The medical reimbursement plan must meet certain nondiscrimination requirements. § 105(h)(2).

[30] Reg. § 1.62–2(c)(4).

[31] *Henry J. Knott*, 67 T.C. 681 (1977).

[32] *Schalk Chemical Co. v. Comm.*, 62–1 USTC ¶9496, 9 AFTR 2d 1579, 304 F.2d 48 (CA–9, 1962).

As a general rule, stock dividends are excluded from income if they are pro rata distributions of stock or stock rights, paid on common stock.[33] However, there are exceptions to this general rule.

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If a stock dividend is not taxable, the corporation's E & P is not reduced.[34] If a stock dividend is taxable, the distributing corporation treats the distribution in the same manner as any other taxable property dividend.

If a stock dividend is taxable, the shareholder's basis of the newly received shares is fair market value, and the holding period starts on the date of receipt. If a stock dividend is not taxable, the basis of the stock on which the dividend is distributed is reallocated.[35] If the dividend shares are identical to these formerly held shares, basis in the old stock is reallocated by dividing the taxpayer's cost in the old stock by the total number of shares. If the dividend stock is not identical to the underlying shares (e.g., a stock dividend of preferred on common), basis is determined by allocating the basis of the formerly held shares between the old and new stock according to the fair market value of each. The holding period includes the holding period of the previously held stock.[36]

EXAMPLE 27

Gail bought 1,000 shares of common stock two years ago for $10,000. In the current tax year, Gail receives 10 shares of common stock as a nontaxable stock dividend. Gail's basis of $10,000 is divided by 1,010. Consequently, each share of stock has a basis of $9.90 instead of the pre-dividend $10 basis. ■

EXAMPLE 28

Assume instead that Gail received a nontaxable preferred stock dividend of 100 shares. The preferred stock has a fair market value of $1,000, and the common stock, on which the preferred is distributed, has a fair market value of $19,000. After the receipt of the stock dividend, the basis of the common stock is $9,500, and the basis of the preferred is $500, computed as follows.

Fair market value of common	$19,000
Fair market value of preferred	1,000
	$20,000
Basis of common: $^{19}/_{20} \times \$10,000$	$ 9,500
Basis of preferred: $^{1}/_{20} \times \$10,000$	$ 500

■

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft.**



10.6 Stock Redemptions

Many investors are tempted to use a "no dividends" strategy in working with a healthy corporation whose accumulated profits and market value continue to rise over time.

LO.7

Understand the tax treatment of stock redemptions and corporate liquidations.

[33]Companies often issue stock dividends or authorize stock splits to keep the stock price in an affordable range. Stock splits do not change the total value of an investment. For example, 100 shares at $100 will become 200 shares at $50 after the split. However, some studies show that a stock split often leads to an upward price trend over the year following the split.

[34]§ 312(d)(1).

[35]§ 307(a).

[36]§ 1223(5).



Bridge to Finance

Stock buybacks are popular among U.S. corporations as a means to manipulate share prices. If a buyback is executed properly, all shareholders retain their respective levels of control over the entity, but because fewer shares now are available on the market, an artificial increase in share price occurs. Often, the market temporarily "over-corrects" for the buyback, probably because of the publicity that the transaction attracts in the press, and the corporation's total capitalized value actually increases.

Most stock buybacks result in dividend income to the shareholders. Stock redemptions of this type generally do not qualify for capital gain/loss treatment under the tax law. Thus, parties must measure the costs associated with an effective distribution of retained earnings in this way. If dividend income is subject to a favorable tax rate, or if the corporate owner of the redeemed shares qualifies for the dividends received deduction, there are few impediments to the plans for the buyback. Tax law changes relative to dividend income, though, may make buybacks less attractive in the future.

EXAMPLE 35

Sally invests $100,000 in the new Cream Corporation. Cream is successful in generating operating profits, and it reinvests its accumulated profits in the business rather than paying dividends. Fifteen years later, Sally's shares are worth $300,000, and her share of Cream's E & P exceeds $1 million. Sally sells the shares for a $200,000 long-term capital gain, taxed at a rate of only 15%. By selling her stock to a third party, Sally can reduce the sales proceeds by her stock basis, resulting in a significant tax savings to her, at no detriment to Cream. ■

A similar strategy would seem to work where several shareholders can act in concert. Using a **stock redemption** to carry out this strategy, the corporation buys back shares from its shareholders in a market transaction. Stock redemptions occur for numerous reasons, including the following.

- To acquire the holdings of a retiring or deceased shareholder.
- To carry out a property settlement related to a divorce.
- To increase the per-share price of the stock as it trades in a market.

EXAMPLE 36

Mike and Cheryl are husband and wife, and each owns 100 shares in Mauve Corporation, the total of all of Mauve's outstanding stock. Mauve's operations have produced a sizable aggregated operating profit over the years, such that its E & P exceeds $5 million. Mike and Cheryl both have realized appreciation of $600,000 on their original investment of $100,000 each, and they would like to enjoy some of the cash that Mauve has accumulated during their holding period. At Mike's request, instead of paying a dividend, Mauve buys back one-half of Mike's shares for $350,000. This seems to produce a $300,000 long-term capital gain [$350,000 (sales proceeds) − $50,000 (basis in 50 shares of Mauve stock)], rather than a $350,000 dividend for Mike. ■

Stock redemptions, however, generally result in dividend income for the shareholder whose stock is redeemed, rather than a sale or exchange, unless the shareholder surrenders significant control in the entity as a result of the redemption. Section 302 allows sale or exchange treatment where either:

- All of the shareholder's stock is redeemed.[37]

[37] § 302(b)(3).

TAX in the NEWS

Capital Restructuring by Charles Schwab Results in Redemption of 102 Million Shares

Flush with cash stemming from the sale of a subsidiary for $3.3 billion, discount stock brokerage firm Charles Schwab Corporation embarked on a restructuring plan that included a special $1.2 billion dividend distribution to shareholders and a redemption of 102 million shares of its stock. The stock buyback included 84 million shares acquired pursuant to a public tender offer and a separate purchase of 18 million shares from the corporation's founder and CEO, Mr. Charles Schwab.

Most of the shareholders who tendered their stock likely qualify for sale or exchange treatment. However, the number of shares redeemed from Mr. Schwab himself depended on the number of shares purchased in the tender offer, and it was designed to keep his ownership interest (approximately 18 percent) intact. Since his proportionate ownership interest in the corporation remained unchanged after the redemption, the distribution to Mr. Schwab ($369 million) most likely is taxed as a dividend. Still, the plan allows Mr. Schwab to reap the benefits of the 15 percent preferential tax rate on dividends.

- After the redemption, the investor is a minority shareholder and owns less than 80 percent of the interest owned in the corporation before the redemption.[38]

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

5 DIGGING DEEPER

When the transaction is treated as a dividend, the investor's basis in the redeemed shares *does not disappear* but attaches to any remaining shares that he or she owns. Corporate E & P is reduced by the amount of any dividend.

Some redemptions can be structured so that shareholders recognize a capital gain, not a dividend.[39] In measuring the investor's stock holdings before and after the redemption, shares owned by related taxpayers also are counted.[40]

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

6 DIGGING DEEPER

Other tax consequences for the redeeming corporation are summarized as follows.

- If noncash property is used to acquire the redeemed shares, the corporation recognizes any realized gain (but not loss) on the distributed assets.[41]
- When the shareholder is taxed as having received a capital gain, E & P of the redeeming corporation *disappears* to the extent of the number of shares redeemed as a percentage of the shares outstanding before the buyback.[42]

Thus, a dividend likely results in Example 30. The strategy illustrated in Example 29, though, can be effective in avoiding dividend income and converting it instead into a long-term capital gain.

[38] § 302(b)(2).

[39] For example, see §§ 302(b)(1), 302(b)(4), and 303.

[40] Section 318 is used for this purpose.

[41] § 311.

[42] The E & P reduction cannot exceed the amount of the redemption proceeds. § 312(n)(7).

Tax Planning Strategies STOCK REDEMPTIONS

FRAMEWORK FOCUS: TAX RATES

Strategy: Control the Character of Income and Deductions.

Stock redemptions offer several possibilities for tax planning.

- The alternative to a qualifying stock redemption is dividend treatment. The 15 percent (0 percent for taxpayers in the 10 or 15 percent marginal tax bracket) preferential tax rate on dividend income reduces some of the adverse consequences of a nonqualified stock redemption for noncorporate shareholders.
- A nonqualified redemption may be preferable to one that produces sale or exchange treatment if the distributing corporation has little or no E & P or the distributee-shareholder is another corporation. In the latter situation, dividend treatment may be preferred due to the availability of the dividends received deduction.
- Stock redemptions are particularly well suited for purchasing the interest of a retiring or deceased shareholder. Rather than the remaining shareholders buying the stock of the retiring or deceased shareholder, corporate funds are used to redeem the stock from the retiring shareholder or from the decedent shareholder's estate. A corporate buy-sell agreement can be used to effect a redemption of a retiring or deceased shareholder's stock. The ability to use the corporation's funds to buy out a shareholder's interest also can be advantageous in property settlements between divorcing taxpayers.
- The timing and sequence of a redemption should be considered carefully, as a series of redemptions still may have the effect of a dividend distribution.

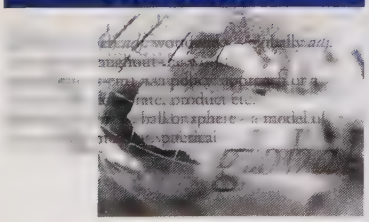
10.7 CORPORATE LIQUIDATIONS

When a corporation makes a nonliquidating distribution (e.g., a cash dividend or a stock redemption), the entity typically continues as a going concern. With a complete liquidation, however, corporate existence terminates, as does the shareholder's ownership interest. A complete liquidation, like a qualifying stock redemption, produces sale or exchange treatment to the *shareholder.* However, the tax effects of a liquidation to the *corporation* vary somewhat from those of a redemption. Sale or exchange treatment is the general rule for the liquidating corporation, although some losses are disallowed.

THE LIQUIDATION PROCESS

A **corporate liquidation** exists when a corporation ceases to be a going concern. The corporation continues solely to wind up affairs, pay debts, and distribute any remaining

GLOBAL *Tax Issues*



FOREIGN SHAREHOLDERS PREFER SALE OR EXCHANGE TREATMENT IN STOCK REDEMPTIONS

As a general rule, foreign shareholders of U.S. corporations are subject to U.S. tax on dividend income but not on capital gains. In some situations, a nonresident alien is taxed on a capital gain from the disposition of stock in a U.S. corporation, but only if the stock was effectively connected with the conduct of a U.S. trade or business of the individual. Foreign corporations are similarly taxed on gains from the sale of U.S. stock investments. Whether a stock redemption qualifies for sale or exchange treatment therefore takes on added significance for foreign shareholders. If one of the qualifying stock redemption rules can be satisfied, the foreign shareholder typically will avoid U.S. tax on the transaction. If, instead, dividend income is the result, a 30 percent withholding tax typically applies.

assets to its shareholders. Legal dissolution under state law is not required for a liquidation to be complete for tax purposes. A liquidation can exist even if the corporation retains a nominal amount of assets to pay remaining debts and preserve legal status.[43]

Shareholders may decide to liquidate a corporation for one or more reasons, including the following.

- The corporate business has been unsuccessful.
- The shareholders wish to acquire the corporation's assets.
- Another person or corporation wants to purchase the corporation's assets. The purchaser may buy the shareholders' stock and then liquidate the corporation to acquire the assets. Alternatively, the purchaser may buy the assets directly from the corporation. After the assets are sold, the corporation distributes the sales proceeds to its shareholders and liquidates.

LIQUIDATING AND NONLIQUIDATING DISTRIBUTIONS COMPARED

As noted previously, a *nonliquidating* property distribution, whether in the form of a dividend or a stock redemption, triggers gain (but not loss) to the distributing corporation. For the shareholder, the receipt of cash or property produces dividend income to the extent of the corporation's E & P or, in the case of a qualifying stock redemption, perhaps results in sale or exchange treatment.

Like a qualifying stock redemption, a complete *liquidation* produces sale or exchange treatment for the shareholders. E & P has no effect on the gain or loss to be recognized by the shareholder in either type of distribution.[44] However, a complete liquidation produces different tax consequences to the liquidating corporation. With certain exceptions, a liquidating corporation recognizes gain *and* loss upon the distribution of its assets.

EXAMPLE 21

Goose Corporation, with E & P of $40,000, makes a cash distribution of $50,000 to its sole shareholder. The shareholder's basis in the Goose stock is $20,000. If the distribution is not a qualifying stock redemption or in complete liquidation, the shareholder recognizes dividend income of $40,000 (the amount of Goose's E & P) and treats the remaining $10,000 of the distribution as a return of capital. If the distribution is a qualifying stock redemption or is pursuant to a complete liquidation, the shareholder recognizes a capital gain of $30,000 ($50,000 distribution − $20,000 stock basis). In the latter case, Goose's E & P is of no consequence to the tax result to the shareholder. ■

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.



Tax Planning Strategies CORPORATE LIQUIDATIONS

FRAMEWORK FOCUS: TAX RATES

Strategy: Avoid Double Taxation.

Usually, distributions in liquidation are taxed at both the corporate level and the shareholder level. When a corporation liquidates, it can, as a general rule, claim losses on assets that have depreciated in value. These assets should not be distributed in the form of a property dividend or stock redemption because losses are not recognized on nonliquidating distributions.

[43]Reg. § 1.332–2(c).

[44]§ 331.

Shareholders faced with large prospective gains in a liquidation may consider shifting part or all of that gain to other taxpayers. One approach is to donate stock to charity. A charitable contribution of the stock produces a deduction equal to the stock's fair market value. Alternatively, the stock may be transferred by gift to family members. If the family member is in the 10 or 15 percent marginal tax bracket, some or all of the gain on liquidation could be taxed at the 0 percent preferential rate on long-term capital gains. However, possible gift tax issues on the stock transfer must be considered (see Chapter 1). Advance planning of stock transfers in the context of a liquidation therefore is crucial in arriving at the desired tax result.

10.8 Restrictions on Corporate Accumulations

Two provisions of the Code are designed to prevent corporations and their shareholders from avoiding the double tax on dividend distributions. Both provisions impose a penalty tax on undistributed income retained by the corporation. The rules underlying these provisions are complex and beyond the scope of this text. However, a brief description is provided as an introduction.

The *accumulated earnings tax*[45] imposes a 15 percent tax on the current year's corporate earnings that have been accumulated without a reasonable business need. The burden of proving what constitutes a reasonable need is borne by the taxpayer. In determining the excessive accumulated income, most businesses are allowed a $250,000 minimum exemption. Thus, most corporations can accumulate $250,000 in earnings over a series of years without fear of an accumulated earnings tax. Beyond the exemption amount, a C corporation's earnings can be accumulated, without incurring the penalty tax, for:

- Working capital needs (to purchase inventory),
- Retirement of debt incurred in connection with the business,
- Investment or loans to suppliers or customers (if necessary to maintain the corporation's business), or
- Realistic business contingencies, including lawsuits or self-insurance.

The *personal holding company (PHC) tax*[46] was enacted to discourage the sheltering of certain kinds of passive income in corporations owned by individuals with high marginal tax rates. Historically, the tax was aimed at "incorporated pocketbooks" that were frequently found in the entertainment and construction industries. For example, a taxpayer could shelter income from securities in a corporation, which would pay no dividends, and allow the corporation's stock to increase in value.

Like the accumulated earnings tax, the PHC tax employs a 15 percent rate and is designed to force a corporation to distribute earnings to shareholders. However, in any single year, the IRS cannot impose both the PHC tax and the accumulated earnings tax. Generally, a company is considered a PHC and may be subject to the tax if:

- More than 50 percent of the value of the outstanding stock was owned by five or fewer individuals at any time during the last half of the year, and
- A substantial portion (60 percent or more) of the corporation's income is comprised of passive types of income, including dividends, interest, rents, royalties, or certain personal service income.

[45] §§ 531–537.

[46] §§ 541–547.

REFOCUS ON THE BIG PICTURE

TAXING CORPORATE DISTRIBUTIONS

A number of factors affect the tax treatment of the corporation's distributions. The amount of current and accumulated E & P partially determines the tax impact on the shareholders. As long as the corporation has sufficient current E & P, the distributions are fully taxable as dividends to Amber and Jimmy. Amber has a taxable dividend equal to the cash received of $80,000 while Jimmy has $20,000 of taxable dividends equal to the $25,000 fair market value of the property he received less the $5,000 mortgage. From the corporation's perspective, the distribution of the appreciated property creates a $15,000 gain on which the corporation owes tax. The gain increases the corporation's E & P by $15,000. The distributions of cash and property then reduce E & P by $80,000 for the cash and $20,000 for the land ($25,000 fair market value reduced by the $5,000 mortgage).

What If?

What if current E & P is less than the value of the cash and land distributed to the shareholders? Current E & P is applied pro rata to the cash and the land based on the fair market values of the distributions. Since the corporation has a deficit in accumulated E & P, the amount of the distributions in excess of the pro rata share of current E & P is treated as a return of capital and reduces the shareholders' basis in their stock.

What if Amber sold 25 percent of her corporate stock to Paulie Corporation, which then receives a $25,000 dividend? In this case, Paulie is entitled to a dividends received deduction equal to 80 percent of the dividend received.

SUGGESTED READINGS

Michelle A. Kassab, "$17.4 Million Bonus Was Reasonable," *Journal of Taxation*, December 2009.

Shawn Novak and Mark Persellin, "Redemption Costs: The Disallowance Provision of § 162(k)," *Corporate Taxation*, January/February 2008.

Robert Willens, "When Is a Distribution a Dividend?" *Journal of Taxation*, June 2005.

John C. Zimmerman, "Constructive Dividend or Compensation," *Corporate Taxation*, March/April 2006.

KEY TERMS

Accumulated E & P, 10–4
Constructive dividend, 10–15
Corporate liquidation, 10–24
Current E & P, 10–4
Dividend, 10–2
Earnings and profits, 10–3
Property dividend, 10–12
Stock dividend, 10–20
Stock redemption, 10–22
Unreasonable compensation, 10–16

PROBLEMS

1. **LO.1, 3** At the start of the current year, Capon Corporation (a calendar year taxpayer) has accumulated E & P of $120,000. Capon's current E & P is $80,000, and during the year, it distributes $220,000 ($110,000 each) to its equal shareholders, Tammy and Mark. Basis in the stock before the distribution is $4,000 for Tammy and $16,000 for Mark. How is the distribution treated for tax purposes?

2. **LO.2** Indigo Corporation, a calendar year taxpayer, receives dividend income of $300,000 from a corporation in which it holds a 10% interest. Indigo also receives interest income of $45,000 from municipal bonds. (The municipality used the proceeds from the bond issue to construct a public library.) Indigo borrowed funds to purchase the municipal bonds and pays $25,000 of interest on the loan. Excluding these items, Indigo's taxable income is $600,000.
   a. What is Indigo's taxable income after these items are taken into account?
   b. What is Indigo's accumulated E & P at the start of the next tax year, if its beginning balance this year is $200,000?

3. **LO.2** Compute current E & P for Jade Corporation (a calendar year, accrual basis taxpayer). Jade had the following transactions during 2010, its second year of operation.

Taxable income	$330,000
Federal income tax liability paid	112,000
Interest income from tax-exempt payors	5,000
Meals and entertainment expenses (total)	3,000
Premiums paid on key employee life insurance	3,500
Increase in cash surrender value attributable to life insurance premiums	700
Proceeds from key employee life insurance policy	130,000
Cash surrender value of life insurance policy at distribution	20,000
Excess of capital losses over capital gains	13,000
MACRS deduction	26,000
Straight-line depreciation using ADS lives	16,000
Section 179 expense elected during 2009	100,000
Organizational expenses incurred in 2009	14,000
Dividends received from domestic corporations (less than 20% owned)	25,000

   - Jade uses the LIFO inventory method, and its LIFO recapture amount increased by $10,000 during 2010.
   - Jade sold some property on installments during 2009. The property was sold for $40,000 and had an adjusted basis at sale of $32,000. During 2010, Jade received a $15,000 payment on the installment sale.
   - Jade elected in 2009 to amortize qualified organizational expenses.

4. **LO.1, 2, 3** On September 30, Sparrow Corporation, a calendar year taxpayer, sold a parcel of land (basis of $300,000) for a $900,000 note. The note is payable in five installments, with the first payment due next year. Because Sparrow did not elect out of the installment method, none of the $600,000 gain is taxed this year.

   Sparrow Corporation had a $400,000 deficit in accumulated E & P at the beginning of the year. Before considering the effect of the land sale, Sparrow had a deficit in current E & P of $100,000.

   Oren, the sole shareholder of Sparrow, has a basis of $150,000 in his stock. If Sparrow distributes $950,000 to Oren on December 31, how much gross income must he report

5. **LO.2** In determining Red Corporation's current E & P for 2010, how should taxable income be adjusted as a result of the following transactions?
   a. Interest on municipal bonds received in 2010.
   b. A capital loss carryover from 2009, fully used in 2010.
   c. Nondeductible meal expenses in 2010.
   d. Loss on a sale between related parties in 2010.

e. Federal income tax refund received in 2010.
f. Nondeductible lobbying expenses in 2010.

6. **LO.1, 3** Gadwall Corporation is a calendar year taxpayer. At the beginning of the current year, Gadwall has accumulated E & P of $350,000. The corporation incurs a current E & P deficit of $400,000 that accrues ratably throughout the year. On September 30, Gadwall distributes $200,000 to its sole individual shareholder, Richard. If Richard has a basis in his stock of $15,000, how is the distribution taxed to him?

7. **LO.1, 3** Complete the following schedule. For each case, assume the shareholder has ample basis in the stock investment.

	Accumulated E & P Beginning of Year	Current E & P	Cash Distributions (All on Last Day of Year)	Dividend Income	Return of Capital
a.	($150,000)	$ 70,000	$130,000	$ _____	$ _____
b.	200,000	(60,000)	210,000	_____	_____
c.	130,000	50,000	150,000	_____	_____
d.	120,000	(40,000)	130,000	_____	_____
e.	Same as (d), except the distribution of $130,000 is made on June 30 and the corporation uses the calendar year for tax purposes.			_____	_____

8. **LO.1, 3** Mia, the sole shareholder of Penguin Corporation, sold her Penguin stock to Sophia on July 30 for $400,000. Mia's basis in the stock was $300,000 at the beginning of the year. Penguin reported accumulated E & P of $220,000 on January 1 and current E & P of $340,000. During the year, Penguin made the following distributions: $600,000 cash to Mia on July 1 and $200,000 cash to Sophia on December 30. How are Mia and Sophia taxed on the distributions? How much gain does Mia recognize on the sale of her stock to Sophia?

9. **LO.2** In each of the following *independent* situations, indicate the effect on taxable income and E & P, stating the amount of any increase (or decrease) as a result of the transaction. Assume E & P has already been increased by taxable income.

	Transaction	Effect on Taxable Income: Increase (Decrease)	E & P Adjustment to Taxable Income: Increase (Decrease)
a.	Realized gain of $90,000 on involuntary conversion of building ($20,000 of gain is recognized).	_____	_____
b.	Mining exploration costs incurred on June 1 of the current year; $36,000 is deductible from current-year taxable income.	_____	_____
c.	Sale of equipment to unrelated third party for $350,000; basis is $210,000 (no election out of installment method; no payments are received in the current year).	_____	_____
d.	Dividends of $30,000 received from 5%-owned corporation, together with dividends received deduction (assume taxable income limit does not apply).	_____	_____
e.	Domestic production activities deduction of $60,000 claimed in current year.	_____	_____

	Transaction	Effect on Taxable Income: Increase (Decrease)	E & P Adjustment to Taxable Income: Increase (Decrease)
f.	Section 179 expense deduction of $60,000 in current year.		
g.	Impact of current-year § 179 expense deduction for item (f) in succeeding year.		
h.	MACRS depreciation of $90,000. ADS depreciation would have been $100,000.		
i.	Federal income taxes paid in the current year of $50,000.		

10. **LO.2** Penguin Corporation (a cash basis, calendar year taxpayer) had the following income and expenses in the current year.

Income from services	$400,000
Salaries paid to employees	70,000
Tax-exempt interest income	24,000
Dividends from a corporation in which Penguin holds a 12% interest	40,000
Short-term capital loss on the sale of stock	17,000
Estimated Federal income taxes paid	110,000

Penguin purchased seven-year MACRS property in the current year for $80,000. No § 179 election was made. The property has a 10-year ADR midpoint life. Determine Penguin's taxable income and current E & P.

11. **LO.1, 3** At the beginning of its taxable year, Turkey Corporation had E & P of $405,000. For the calendar year, Turkey incurred a deficit in current E & P of $550,000, which includes a $405,000 loss on the sale of an asset on June 30. If Turkey made a distribution of $75,000 to its sole shareholder on July 1, how is the shareholder taxed?

12. **LO.1, 3** Bunting Corporation (a calendar year taxpayer) had a deficit in accumulated E & P of $250,000 at the beginning of the current year. Its net profit for the period January 1 through September 30 was $300,000, but its E & P for the entire taxable year was only $40,000. If Bunting made a distribution of $60,000 to its sole shareholder on October 1, how will the shareholder be taxed?

13. **LO.1, 3** Eagle Corporation and Jack each own 50% of Hawk Corporation's common stock. On January 1, Hawk reports a deficit in accumulated E & P of $300,000. Its current E & P is $130,000. During the year, Hawk makes cash distributions of $60,000 each to Eagle and Jack.
    a. How are the two shareholders taxed on the distribution?
    b. What is Hawk Corporation's accumulated E & P at the end of the year?

14. **LO.1, 4** Kathryn owns all of the outstanding stock in Copper Corporation. Kathryn purchased her stock in Copper 11 years ago, and her basis is $18,000. At the beginning of this year, the corporation has $38,000 of accumulated E & P and no current E & P (before considering the effect of the distributions). What are the tax consequences to Kathryn (amount and type of income and basis in property received) and Copper Corporation (gain or loss and effect on E & P) in each of the following situations?
    a. Copper distributes land to Kathryn. The land was held as an investment and has a fair market value of $28,000 and an adjusted basis of $21,000.
    b. Assume that Copper Corporation has no current or accumulated E & P prior to the distribution. How would your answer to (a) change?
    c. Assume that the land distributed in (a) is subject to a $23,000 mortgage (which Kathryn assumes). How would your answer change?
    d. Assume that the land has a fair market value of $28,000 and an adjusted basis of $31,000 on the date of the distribution. How would your answer to (a) change?

e. Instead of distributing land, assume that Copper decides to distribute furniture used in its business. The furniture has a $7,000 fair market value, a $600 adjusted basis for income tax purposes, and a $2,600 adjusted basis for E & P purposes. When the furniture was purchased four years ago, its original fair market value was $9,000.

15. **LO.1, 4** Green Corporation, with E & P of $600,000, distributes land (worth $300,000, adjusted basis of $340,000) to Michael, its sole shareholder. The land is subject to a liability of $130,000, which Michael assumes. What are the tax consequences to Green and to Michael?

16. **LO.4** Raven Corporation owns three automobiles that it uses in its business. It no longer needs two of these cars and is considering the possibility of distributing them to its two shareholders as a property dividend. All three automobiles have a fair market value of $20,000. Automobile A has a basis of $27,000; automobile B has a basis of $20,000; and automobile C has a basis of $12,000. The corporation has asked you for advice. What actions do you recommend? **DECISION MAKING**

17. **LO.1, 2, 3, 4** Cerulean Corporation has two equal shareholders, Eloise and Olivia. Eloise acquired her Cerulean stock three years ago by transferring property worth $700,000, basis of $300,000, for 70 shares of the stock. Olivia acquired 70 shares in Cerulean Corporation two years ago by transferring property worth $660,000, basis of $110,000. Cerulean Corporation's accumulated E & P as of January 1 of the current year is $350,000. **ISSUE ID**

On March 1 of the current year, the corporation distributed to Eloise property worth $120,000, basis to Cerulean of $50,000. It distributed cash of $220,000 to Olivia. On July 1 of the current year, Olivia sold her stock to Magnus for $820,000. On December 1 of the current year, Cerulean distributed cash of $90,000 each to Magnus and Eloise. What are the tax issues?

18. **LO.1, 2, 4** Purple Corporation has accumulated E & P of $65,000 at the beginning of the year. Its current-year taxable income is $320,000. On December 31, Purple distributed business property (worth $140,000, adjusted basis of $290,000) to Peter, its sole shareholder. Peter assumes an $80,000 liability on the property. Included in the determination of Purple's current taxable income is $16,000 of income recognized from an installment sale in a previous year. In addition, the corporation incurred a Federal income tax liability of $112,000, paid life insurance premiums of $3,500, and received term life insurance proceeds of $55,000 on the death of an officer. **DECISION MAKING**

a. What is Peter's taxable income?
b. What is the E & P of Purple Corporation after the property distribution?
c. What is Peter's tax basis in the property received?
d. How would your answers to (a) and (b) change if Purple had sold the property at its fair market value, used $80,000 of the proceeds to pay off the liability, and then distributed the remaining cash and any tax savings to Peter?

19. **LO.5** Parrot Corporation is a closely held company with accumulated E & P of $300,000 and current E & P of $350,000. Tom and Jerry are brothers; each owns a 50% share in Parrot, and they share management responsibilities equally. What are the tax consequences of each of the following independent transactions involving Parrot, Tom, and Jerry? How does each transaction affect Parrot's E & P?

a. Parrot sells an office building (adjusted basis of $350,000; fair market value of $300,000) to Tom for $275,000.
b. Parrot lends Jerry $250,000 on March 31 of this year. The loan is evidenced by a note and is payable on demand. No interest is charged on the loan (the current applicable Federal interest rate is 7%).
c. Parrot owns an airplane that it leases to others for a specified rental rate. Tom and Jerry also use the airplane for personal use and pay no rent. During the year, Tom used the airplane for 120 hours, and Jerry used it for 160 hours. The rental value of the airplane is $350 per hour, and its maintenance costs average $80 per hour.
d. Tom leases equipment to Parrot for $20,000 per year. The same equipment can be leased from another company for $9,000 per year.

20. **LO.5** Orange Corporation would like to transfer excess cash to its sole shareholder, Danielle, who is also an employee. Danielle is in the 28% tax bracket, and Orange is in **DECISION MAKING**

the 34% bracket. Because Danielle's contribution to Orange's profit is substantial, Orange believes that a $50,000 bonus in the current year is reasonable compensation and should be deductible in full. However, Orange is considering paying Danielle a $50,000 dividend because Danielle's tax rate on dividends is lower than her tax rate on compensation. Is Orange correct in believing that a dividend is the better choice? Why or why not?

COMMUNICATIONS

21. **LO.1, 3** Your client, Heron Corporation, has a deficit in accumulated E & P of $300,000. Starting this year, it expects to generate annual E & P of $150,000 for the next four years and would like to distribute this amount to its shareholders. How should Heron Corporation distribute the $600,000 over the four-year period to provide the least amount of dividend income to its shareholders (all individuals)?

In a letter to your client, make appropriate suggestions on how this should be done. Heron Corporation's address is 12 Nature Trail Way, Daytona Beach, FL 32114.

CRITICAL THINKING

22. **LO.6** Katie purchased 5,000 shares of Grebe Corporation common stock six years ago for $80,000. In the current year, Katie received a preferred stock dividend of 400 shares, while the other holders of common stock received a common stock dividend. The preferred stock Katie received is worth $40,000, and her common stock has a fair market value of $120,000. Assume that Grebe has ample E & P to cover any distributions made during the year. What is Katie's basis in the preferred and common stock after the dividend is received? When does her holding period commence for the preferred stock?

CRITICAL THINKING

23. **LO.6** Denim Corporation declares a nontaxable dividend payable in rights to subscribe to common stock. One right and $60 entitle the holder to subscribe to one share of stock. One right is issued for every two shares of stock owned. At the date of distribution of the rights, the market value of the stock is $110 per share, and the market value of the rights is $55 each. Lauren owns 300 shares of stock that she purchased two years ago for $9,000. Lauren receives 150 rights, of which she exercises 105 to purchase 105 additional shares. She sells the remaining 45 rights for $2,475. What are the tax consequences of this transaction to Lauren?

CRITICAL THINKING

COMMUNICATIONS

24. **LO.6** Julie Swanson bought 5,000 shares of Great Egret Corporation stock two years ago for $12,000. Last year, Julie received a nontaxable stock dividend of 1,000 shares in Great Egret Corporation. In the current tax year, Julie sold all of the stock received as a dividend for $9,000. Prepare a letter to Julie and a memo to the file describing the tax consequences of the stock sale. Julie's address is 3737 Canyon Drive, Minneapolis, MN 55434.

ISSUE ID

25. **LO.7** Joseph and Erica, husband and wife, jointly own all of the stock in Velvet Corporation. The two are currently involved in divorce proceedings, and pursuant to those negotiations they have agreed that only one of them will remain a shareholder in Velvet after the divorce. Since Erica has been more involved in Velvet's management and operations over the years, the parties have agreed that Joseph's ownership should be acquired by either Erica or Velvet. What issues should be considered in determining whether Erica or Velvet should acquire Joseph's shares in the corporation?

26. **LO.1, 7** Julio is in the 35% tax bracket. He acquired 1,000 shares of stock in Gray Corporation seven years ago at a cost of $250 per share. In the current year, Julio received a payment of $500,000 from Gray Corporation in exchange for 600 of his shares in Gray. Gray has E & P of $1 million. What tax liability would Julio incur on the $500,000 payment in each of the following situations? Assume that Julio has no capital losses.

a. The payment qualifies for stock redemption (i.e., sale or exchange) treatment.
b. The payment does not qualify for stock redemption (i.e., sale or exchange treatment is not applicable) treatment.

27. **LO.1, 7** How would your answer to Problem 26 differ if Julio were a corporate shareholder (in the 34% tax bracket) rather than an individual shareholder and the stock ownership in Gray Corporation represented a 15% interest?

DECISION MAKING

28. **LO.1, 7** Assume in Problem 26 that Julio has a capital loss carryover of $110,000 in the current tax year. Julio has no other capital gain transactions during the year. What amount of the capital loss may Julio deduct in the current year in the following situations?

a. The $500,000 payment from Gray Corporation is a qualifying stock redemption for tax purposes (i.e., receives sale or exchange treatment).
b. The $500,000 payment from Gray Corporation does not qualify as a stock redemption for tax purposes (i.e., does not receive sale or exchange treatment).
c. If Julio had the flexibility to structure the transaction as described in either (a) or (b), which form would he choose?

29. **LO.1, 7** How would your answer to parts (a) and (b) of Problem 28 differ if Julio were a corporate shareholder (in the 34% tax bracket) rather than an individual shareholder and the stock ownership in Gray Corporation represented a 15% interest?

30. **LO.7** Shawn owns 200 of the 1,000 shares outstanding of Hawk Corporation (E & P of $700,000). Shawn paid $150 per share for the stock nine years ago. The remaining stock in Hawk is owned as follows: 600 shares by Vulture Corporation and 200 shares by several unrelated individuals. Shawn owns 70% of the stock of Vulture. In the current year, Hawk redeems 100 shares of Shawn's stock for $125,000.
a. How is the distribution taxed to Shawn?
b. What is Shawn's basis in his remaining 100 shares of Hawk?
c. What is Hawk's E & P after the redemption?

31. **LO.7** Teal Corporation (E & P of $900,000) has 2,000 shares of common stock outstanding. The shares are owned by the following individuals: Ann, 800 shares; Bonnie, 600 shares; and Lucy, 600 shares. Each of the shareholders paid $20 per share for the Teal stock nine years ago. In the current year, Teal distributes $90,000 to Ann in redemption of 300 of her shares. Determine the tax consequences of the redemption to Ann and to Teal under the following independent circumstances.
a. The three shareholders are unrelated.
b. Ann and Bonnie are mother and daughter.

32. **LO.7** Sean owns 1,000 shares or 40% of the outstanding stock of Crane Corporation (E & P of $900,000). Sean purchased the stock 15 years ago for $50,000. For the last eight years, Crane has owned and operated three different trades or businesses. Pursuant to a plan adopted in the current year, Crane Corporation sells one of those trades or businesses and distributes the proceeds from such sale to its shareholders pursuant to a stock redemption. **CRITICAL THINKING**

Sean received a distribution of $200,000 in redemption of 500 shares of Crane stock. Determine the tax consequences of the redemption to Sean and to Crane Corporation under the following independent circumstances.
a. Sean is an individual.
b. Sean is a corporation.

33. **LO.7** Cardinal Corporation has 1,000 shares of common stock outstanding. Hubert owns 300 of the shares, Hubert's father owns 100 shares, Hubert's uncle owns 100 shares, and Redbird Corporation owns 400 shares. Hubert owns 80% of the stock in Redbird. **CRITICAL THINKING**
a. Applying the § 318 stock attribution rules, how many shares does Hubert own in Cardinal?
b. Assume Hubert owns only 40% of Redbird. How many shares does Hubert own directly and indirectly in Cardinal?
c. Assume the same facts as in (a) above, but in addition, Hubert owns 30% of Yellow Partnership. The partnership owns 100 shares in Cardinal. How many shares does Hubert own directly and indirectly in Cardinal?

34. **LO.7** Compare the tax treatment of liquidating and redemption distributions in terms of the following. **CRITICAL THINKING**
a. Recognition of gain or loss by the shareholder.
b. Basis of property received by the shareholder.

35. **LO.7** The stock of Hawk Corporation is owned equally by three sisters, Michele, Melanie, and Miranda. Hawk owns land (basis of $250,000, fair market value of $210,000) that it has held for investment for eight years. When Michele's basis in her stock is $225,000, Hawk distributes the land to her in exchange for all of her shares. What are the tax consequences for both Hawk and Michele if the distribution is a: **CRITICAL THINKING**
a. Qualifying stock redemption?
b. Liquidating distribution?

ISSUE ID

36. **LO.7** Pink Corporation has several employees. Their names and salaries are listed below.

Judy	$470,000
Holly (Judy's daughter)	100,000
Terry (Judy's son)	100,000
John (an unrelated third party)	320,000

Holly and Terry are the only shareholders of Pink Corporation. Judy and John share equally in the management of the company's operations. Holly and Terry are both full-time college students at a university 300 miles away. Pink has substantial E & P and has never distributed a dividend. Discuss problems related to Pink's salary arrangement.

Bridge DISCIPLINE

1. Find the audited financial statements of five major U.S. corporations, each in a different operating industry (e.g., manufacturing, energy, financial services, health care).
   a. Compute the total return on each corporation's stock for the past two years.
   b. Compute the dividend yield of the stock for the past two years.

RESEARCH PROBLEMS

THOMSON REUTERS
Checkpoint® Student Edition

Note: Solutions to Research Problems can be prepared by using the **Checkpoint® Student Edition** online research product, which is available to accompany this text. It is also possible to prepare solutions to the Research Problems by using tax research materials found in a standard tax library.

COMMUNICATIONS

Research Problem 1. Patrick Zimbrick and his son, Dan, own all of the outstanding stock of Osprey Corporation. Both Dan and Patrick are officers in the corporation and, together with their uncle, John, comprise the entire board of directors. Osprey uses the cash method of accounting and a calendar year-end. In late 2006, the board of directors adopted the following legally enforceable resolution (agreed to in writing by each of the officers).

> Salary payments made to an officer of the corporation that are disallowed in whole or in part as a deductible expense for Federal income tax purposes shall be reimbursed by such officer to the corporation to the full extent of any disallowance. It is the duty of the board of directors to enforce repayment of each such amount.

In 2007, Osprey paid Patrick $560,000 in compensation. Dan received $400,000. On audit in late 2010, the IRS found the compensation of both officers to be excessive. It disallowed deductions for $200,000 of the payment to Patrick and $150,000 of the payment to Dan. The IRS recharacterized the disallowed payments as constructive dividends. Complying with the resolution by the board of directors, both Patrick and Dan repaid the disallowed compensation to Osprey Corporation in early 2011. Dan and Patrick have asked you to determine how their repayments should be treated for tax purposes. Prepare a memo to your files describing the results of your research.

Research Problem 2. Your client, Purple Corporation, has done well since its formation 20 years ago. This year, it recognized a $50 million capital gain from the sale of a subsidiary. Purple's CEO has contacted you to discuss a proposed transaction to reduce the tax on the capital gain. Under the proposal, Purple will purchase all of the common stock in Yellow Corporation for $200 million. Yellow is a profitable corporation that has $63 million in cash and marketable securities, $137 million in operating assets, and approximately $280 million in E & P. After its acquisition, Yellow will distribute $50 million in cash and marketable securities to Purple. Due to the 100% dividends received deduction, no taxable income results to Purple from the dividend. Purple will then resell Yellow for $150 million. The subsequent sale of Yellow generates a $50 million capital loss [$150 million (sale price) – $200 million (stock basis)]. The loss from the stock sale can then be used to offset the preexisting $50 million capital gain. Will the proposed plan work?

Partial list of research aids:
§ 1059.



Use the tax resources of the Internet to address the following questions. Do not restrict your search to the Web, but include a review of newsgroups and general reference materials, practitioner sites and resources, primary sources of the tax law, chat rooms and discussion groups, and other opportunities.

Research Problem 3. Just how common are dividend distributions in today's economic climate? Are dividends concentrated in the companies traded on the New York Stock Exchange, or do closely held corporations pay dividends with the same frequency and at the same rates? Did dividends decrease during the financial downturn of 2008 and 2009? Financial institutions and observers are acutely interested in these issues. Search for comments on such questions at various commercial websites as well as one or two academic journals or newsgroups.

Research Problem 4. Investigate websites of for-profit investment managers and summarize the information you find in a two-page discussion, entitled "The Market in Stock Splits: How You Can Profit." Submit the summary to your professor.

COMMUNICATIONS

Research Problem 5. Write an e-mail query to two tax consultants who practice in your state. Ask each for an example or two of a constructive dividend that a client recently has paid. Give your instructor copies of your query and the responses you receive.

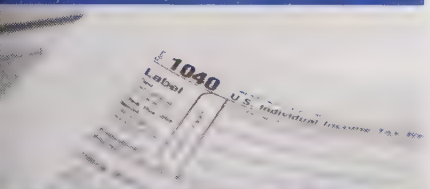
COMMUNICATIONS

Research Problem 6. Publicly traded corporations reacquire their own shares for several reasons. Through the use of a tender offer, a corporation can purchase a substantial percentage of the company's stock. Using the Internet as your sole research source, prepare an outline discussing (1) reasons why publicly traded corporations reacquire their own shares and (2) how the tender offer process works for both corporations and shareholders.

COMMUNICATIONS

CHAPTER 11

Partnerships and Limited Liability Entities



LEARNING OBJECTIVES

After completing Chapter 11, you should be able to:

LO.1 Discuss governing principles and theories of partnership taxation. **(pp.11-2 to 11-9)**

LO.2 Describe the tax effects of forming a partnership with cash and property contributions. **(pp.11-9 to 11-14)**

LO.3 Determine the tax treatment of expenditures of a newly formed partnership and identify elections available to the partnership. **(pp.11-14 to 11-16)**

LO.4 Calculate partnership taxable income and describe how partnership items affect a partner's income tax return. **(pp.11-16 to 11-20)**

LO.5 Determine a partner's basis in the partnership interest. **(pp.11-21 to 11-26)**

LO.6 Apply the limitations on deducting partnership losses. **(pp.11-26 to 11-29)**

LO.7 Use the tax laws regarding transactions between a partner and the partnership. **(pp.11-30 to 11-33)**

LO.8 Apply partnership tax law provisions to limited liability companies (LLCs) and limited liability partnerships (LLPs). **(pp.11-33 to 11-35)**

TAX *Talk*

If you are truly serious about preparing your child for the future, don't teach him to subtract—teach him to deduct.

—Fran Lebowitz

OUTLINE

11.1 Overview of Partnership Taxation, 11-2
Forms of Doing Business—Federal Tax Consequences, 11-3
What Is a Partnership? 11-4
Partnership Taxation and Reporting, 11-5
Partner's Ownership Interest in a Partnership, 11-8
11.2 Formation of a Partnership: Tax Effects, 11-9
Gain or Loss on Contributions to the Partnership, 11-9
Exceptions to Nonrecognition, 11-10
Tax Issues Related to Contributed Property, 11-11
Inside and Outside Bases, 11-13
Tax Accounting Elections, 11-14
Initial Costs of a Partnership, 11-14
11.3 Operations of the Partnership, 11-16
Reporting Operating Results, 11-16
Partnership Allocations, 11-19
Basis of a Partnership Interest, 11-21
Partner's Basis, Gain, and Loss, 11-23
Loss Limitations, 11-26
11.4 Transactions between Partner and Partnership, 11-30
Guaranteed Payments, 11-30
Other Transactions between a Partner and a Partnership, 11-31
Partners as Employees, 11-32
11.5 Limited Liability Entities, 11-33
Limited Liability Companies, 11-33
Limited Liability Partnerships, 11-35
11.6 Summary, 11-36

THE BIG PICTURE Tax Solutions for the Real World

THE TAX CONSEQUENCES OF PARTNERSHIP FORMATION AND OPERATIONS

Walter is interested in developing land that he owns, but he lacks the cash and knowledge to accomplish the development on his own. The property is substantially appreciated real estate valued at $900,000 (basis of $300,000) that has been "site prepped" by grading the property and running water and electricity to the site. The property is zoned for commercial uses.

Grace has $650,000 of cash that she intends to invest. She also owns construction equipment valued at $250,000 from an earlier business venture. The equipment has a basis of zero.

Frank has expertise in real estate and construction and has convinced Walter and Grace to develop a shopping center called Cedar Creek Commons on the land. Initially, the plans call for an upscale grocery store and a few small shops. Land is available, however, to expand operations when a nearby residential development opens and the new residents can support additional retail outlets.

Frank will manage construction of the project and obtain the retail tenants in exchange for a 10 percent interest in the venture. Frank's services are valued at $200,000. On an ongoing basis, Frank will also manage the venture and is to be allocated 25 percent of the partnership's income and cash flow.

What are the tax consequences if the trio forms a partnership to own and operate Cedar Creek Commons? What issues might arise later in the life of the partnership? **Read the chapter and formulate your response.**

11.1 Overview of Partnership Taxation

LO.1
Discuss governing principles and theories of partnership taxation.

Much of the new business in today's world of commerce is conducted in what the Internal Revenue Code would classify as *partnerships*. As evidence of their popularity, about 3 million partnership tax returns are filed with the IRS annually.

Whether termed a *joint venture, working agreement, shared operating arrangement,* or some other designation, a partnership is formed when individuals or separate business entities get together for the specific purpose of earning profits by jointly operating a trade or business. For example, a partnership likely exists when a U.S. business enters into a joint venture with a foreign distributor to gain access to an overseas consumer market. Or a number of businesses located in a blighted downtown area might work together to boost sales and customer traffic by forming a group that



PARTNERSHIP POWER

Partnerships represent a sizable number of business entities, and they generate a significant part of the net income of the economy, especially in the investment sectors. The table below presents some statistics about the activities of partnerships from the most recent year for which data are available.

Partnership Activities, Tax Year 2007	
Number of partnerships	3,100,000
Number of partners	18,500,000
Reported partnership net income—total	$685 billion
Reported partnership business income	$305 billion
Reported partnership portfolio income	$980 billion
Reported partnership rental real estate income	($ 1.2 billion)

unifies and improves the appearance of the storefronts in the area, conducts joint advertising, and coordinates sales and coupon activities.

Partnerships allow a great degree of flexibility in the conduct of business: for example, a group can limit its goals to a specific list of agreed-to projects or to a given time period, or businesses can work together without altering any of their underlying capital structures. In many service professions, such as law, medicine, and accounting, state laws prohibit the owners from using a corporation to limit their liability to clients or patients, so the partnership form prevails.

The tax law addressing the transactions of partners and partnerships is found in Subchapter K of the Internal Revenue Code. These provisions comprise only a few short pages in the Code, however. Most of the details of partnership tax law have evolved through extensive Regulations and a healthy number of court cases.

FORMS OF DOING BUSINESS—FEDERAL TAX CONSEQUENCES

This chapter and the next chapter analyze business forms that offer certain advantages over C corporations. These entities are partnerships and S corporations, which are called *flow-through* or *pass-through* entities because the owners of the trade or business elect to avoid treating the enterprise as a separate taxable entity. Instead, the owners are taxed on a proportionate share of the firm's taxable income at the end of each of its taxable years, regardless of the amount of cash or property distributions the owners receive during the year. The entity serves as an information provider to the IRS and its owners with respect to the proportionate income shares, and the tax falls directly upon the owners of those shares.

A partnership may be especially advantageous in many cases. A partnership's income is subject to only a single level of taxation, whereas C corporation income can be subject to *double taxation*. Corporate income is taxed at the entity level at rates up to 35 percent. Any after-tax income that is distributed to corporate owners is taxed again as a dividend at the owner level. Though partnership income may be subject to high individual rates, the resulting tax likely will be lower than a combined corporate-level tax and a second tax on dividends.

In addition, the entity offers certain planning opportunities not available to other entities. Both C and S corporations are subject to rigorous allocation and distribution requirements (generally, each allocation or distribution is proportionate to the ownership interest of the shareholder). A partnership, though, may adjust its



BRIDGE TO FINANCE

As movies have become more expensive to produce, many production studios have turned to limited partnerships as a lucrative source of investment capital. For example, several well-known studios have sold limited partnership or LLC interests in entities formed to produce specific movies.

The sponsoring studio usually injects capital for a small (1–5 percent) general partnership interest, and the limited partners contribute the remaining capital—millions of dollars in most cases. The partnership agreement spells out the number and types of films the partnership intends to produce and provides a formula for allocating cash flows to the partners. The agreement includes various benefits for the general partner (studio), such as a preferred allocation of cash flows (the first $1 million per year, for example), distribution fees for marketing the movies, and/or reimbursement of specified amounts of corporate overhead. Any cash remaining after these expenses is allocated under a fixed formula between the general and limited partners (for example, the limited partners may receive 90 percent of remaining cash flows).

These film-financing partnerships are not necessarily private operations. A layperson with a well-connected tax or investment adviser can become a partner in the next Katherine Heigl project, perhaps financed by Silver Screen Partners. Partnership shares sell for multiples of $100,000 or more, and in return the investor can become part-owner in an entity that is certain to throw off operating losses for many years to come.

Especially interested in movie financing of this type can be non-U.S. investors. The use of partnerships and limited liability entities is a common way to attract cross-border investment, as many developed countries treat such joint ventures favorably under their tax laws, allowing deferral of income recognition and lower tax withholding on the income of these entities. U.S. investors are attracted to joint venture financing of film projects in several countries, including Germany and Canada, and U.S. states, including Illinois and Louisiana, that offer generous tax credits for projects that are filmed and processed chiefly within their borders. The partnership tax regime can offer an immediate flow-through of these tax benefits.

Think about traditional bank financing of manufacturing or distribution activities in comparison, and you will see why the movie studio finds partnerships so appealing: How many banks would allow the general partner to receive reimbursements and allocations before debt principal and interest are paid?

This capital-raising technique has proved so advantageous to the studios that some related industries, such as movie lighting contractors and special effects companies, also use limited partnerships to raise capital. The next time you go to a movie, watch the credits at the end and think about the large number of people who invested cash in the movie hoping for a blockbuster!

allocations of income and cash flow among the partners each year according to their needs, as long as certain standards are met. Any previously unrealized income (such as appreciation of corporate assets) of a C corporation is recognized at the entity level when the corporation liquidates, but a partnership generally may liquidate tax-free. Finally, many states impose reporting and licensing requirements on corporate entities, including S corporations. These include franchise or capital stock tax returns that may require annual assessments and costly professional preparation assistance. Partnerships, on the other hand, often have no reporting requirements beyond Federal and state informational tax returns.

Although partnerships may avoid many of the income tax and reporting burdens faced by other entities, they are subject to all other taxes in the same manner as any other business. Thus, the partnership files returns and pays the outstanding amount of pertinent sales taxes, property taxes, and payroll taxes.

In summary, partnerships offer advantages to both large and small businesses. For smaller business operations, a partnership enables several owners to combine their resources at low cost. For larger business operations, a partnership offers a unique ability to raise capital with low filing and reporting costs (compared to corporate bond issuances, for example).

WHAT IS A PARTNERSHIP?

A partnership is an association of two or more persons formed to carry on a trade or business, with each contributing money, property, labor, or skill, and with all expecting to share in profits and losses. A "person" can be an individual, a corporation, or another partnership. For Federal income tax purposes, a partnership includes a

TAX in the NEWS

A Partnership with Limits

Also on the scene of business entities is the **limited liability limited partnership** (LLLP or "triple-LP"). Currently permitted by about 20 states, the LLLP is an extension of a limited partnership under which general partners also are protected from entity liability. Accordingly, in an LLLP all partners, whether general or limited, are accorded limited liability. Existing limited partnerships can acquire LLLP status by filing a proper request with the appropriate state.

syndicate, group, pool, joint venture, or other unincorporated organization, through which any business, financial operation, or venture is carried on. The entity must not be otherwise classified as a corporation, trust, or estate.[1]

An eligible entity can "check the box" on the partnership tax return indicating that the entity wants to be taxed as a partnership.[2] A partnership must have at least two owners, so a sole proprietor or one-shareholder LLC or corporation cannot "check the box" and be taxed as a partnership.[3]

Businesses operating in several forms are taxed as partnerships. Provisions controlling these legal forms of doing business typically are dictated by the laws of the states in which the businesses operate.

- In a **general partnership**, the partners share profits and losses in some specified manner, as dictated by the partnership agreement. Creditors can reach the assets of the business and the personal assets of the general partners to satisfy any outstanding debts. A general partner can be bankrupted by a judgment against the entity, even though the partner did not cause the violation triggering the damages.
- In a **limited partnership**, profits and losses are shared as the partners agree, but ownership interests are either general (creditors can reach the personal assets of the partner) or limited (a partner's exposure to entity liabilities is limited to the partner's own capital contributions). Usually, the general partners conduct most of the partnership business, and they have a greater say in making decisions that affect the entity operations.
- The **limited liability partnership (LLP)** is used chiefly in the service professions, such as accounting and consulting. The primary difference between an LLP and a general partnership is that an LLP partner is not personally liable for acts of negligence, fraud, or malpractice committed by other partners.
- The **limited liability company (LLC)** is discussed in more detail later in this chapter. This entity is taxed as a partnership, but its capital structure resembles that of a corporation, with shares for sale and an owner's liability limited almost strictly to the extent of capital contributions. Some states allow LLCs to be owned solely by one person.

PARTNERSHIP TAXATION AND REPORTING

A partnership is not a taxable entity.[4] Rather, the taxable income or loss of the partnership flows through to the partners at the end of the entity's tax year.[5] Partners report their allocable share of the partnership's income or loss for the year on their tax returns. As a result, the partnership itself pays no Federal income tax on its income; instead, the partners' individual tax liabilities are affected by the activities of the entity.

EXAMPLE 1

Adam is a 40% partner in the ABC Partnership. Both Adam's and the partnership's tax years end on December 31. This year, the partnership generates $200,000 of ordinary

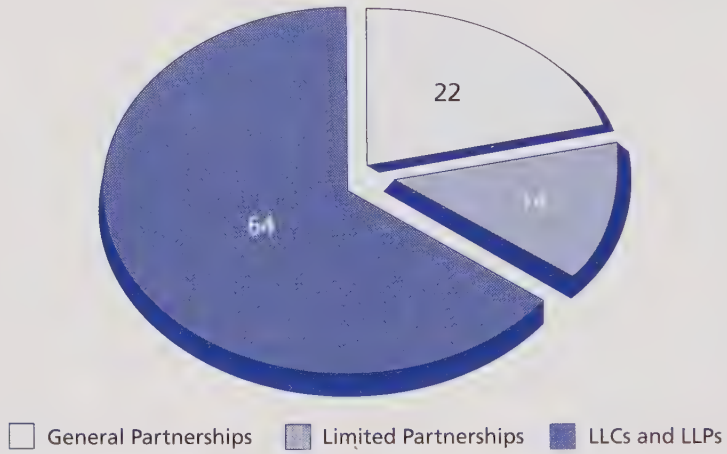
[1] § 7701(a)(2).
[2] Reg. §§ 301.7701–1 to 301.7701–3, as discussed in Chapter 9.
[3] § 761(a).
[4] § 701.
[5] § 702.

TAX

LOOK AT ALL THE LLCs

LLCs and LLPs have become so popular that there are more of them than there are reporting general partnerships.

Percentage of U.S. Entities Reporting, Tax Year 2007



taxable income. However, because the partnership needs capital for expansion and debt reduction, Adam makes no cash withdrawals during the year. He meets his living expenses by reducing his investment portfolio. Adam is taxed on his $80,000 allocable share of the partnership's income ($200,000 × 40%), even though he received no distributions from the entity during the year. This allocated income is included in Adam's gross income. ■

EXAMPLE 2

Assume the same facts as in Example 1, except that the partnership realizes a taxable loss of $100,000. Adam's $40,000 proportionate share of the loss flows through to him from the partnership, and he can deduct the loss. (Note: Loss limitation rules discussed later in the chapter may result in some or all of this loss being deducted by Adam in a later year.) ■

Many items of partnership income, expense, gain, or loss retain their tax identity as they flow through to the partners. These **separately stated items** include those items that may affect any two partners' tax liability computations differently.[6] For example, the § 179 expense of a partnership is separately stated because one partner might be able to deduct his or her share of the expense completely, while another's deduction might be limited. Separately stated items include recognized gains and losses from property transactions, dividend income, preferences and adjustments for the alternative minimum tax (see Chapter 14), foreign tax payments, and expenditures that individual partners would treat as itemized deductions (e.g., charitable contributions).

Items that are not separately stated, because all partners treat them the same on their income tax returns, are aggregated and form the *ordinary income* of the partnership. Thus, profits from product sales, advertising expenses, and depreciation recapture amounts are combined to form the entity's ordinary income. This amount then is allocated among the partners and flows through to their tax returns. The ordinary income that flows through to a general partner, as well as any salary-like guaranteed payments (discussed in a later section) received, usually is subject to self-employment tax, as well as Federal income tax.[7]

EXAMPLE 3

Beth is a 25% partner in the BR Partnership. The cash basis entity collected sales income of $60,000 and incurred $15,000 in business expenses. In addition, it sold a corporate

[6] § 703(a)(1).

[7] § 1402(a).

bond for a $9,000 long-term capital gain. Finally, the partnership made a $1,000 contribution to the local Performing Arts Fund drive. The fund is a qualifying charity. BR and all of its partners use a calendar tax year.

Beth is allocated ordinary taxable income of $11,250 [($60,000 − $15,000) × 25%] from the partnership. She also reports her allocated share of the entity's long-term capital gain ($2,250) and charitable contributions ($250). The ordinary income increases Beth's gross income, and the capital gain and charitable contribution are combined with her other similar activities for the year as though she had incurred them herself. These items could be treated differently on the tax returns of the various partners (e.g., because a partner may be subject to a percentage limitation on charitable contribution deductions), so they are not included in the computation of ordinary partnership income. Instead, the items flow through to the partners separately. ■

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.



Even though it is not a taxpaying entity, the partnership files an information tax return, Form 1065. This return is due by the fifteenth day of the fourth month following the end of the tax year. For a calendar year partnership, this deadline is April 15. An automatic five-month extension is available (to September 15 for a calendar year partnership). As part of this return, the partnership prepares a Schedule K–1 for each partner that shows that partner's share of partnership items. The partnership pays a penalty if it fails to file a timely (by the extended due date) Form 1065. The penalty is $195 per month times the numbers of partners, up to a maximum of 12 months.

Look at Form 1065 in Appendix B, and refer to it during the following discussion. The ordinary income and expense items generated by the partnership's trade or business activities are netted to produce a single income or loss amount. The partnership reports this ordinary income or loss from its trade or business activities on Form 1065, page 1. Schedule K (page 4 of Form 1065) accumulates all items that must be separately reported to the partners, including net trade or business income or loss (from page 1). The amounts on Schedule K are allocated among and reported by the partners on each owner's Schedule K–1.

EXAMPLE

The BR Partnership in Example 3 reports its $60,000 of sales income on Form 1065, page 1, line 1. The $15,000 of business expenses are reported in the appropriate amounts on page 1, line 2 or lines 9–20. Partnership ordinary income of $45,000 is shown on page 1, line 22, and on Schedule K, line 1. The $9,000 capital gain and the $1,000 charitable contribution are reported only on Schedule K, on lines 9a and 13a, respectively.

Beth receives a Schedule K–1 from the partnership that shows her shares of partnership ordinary income of $11,250, long-term capital gain of $2,250, and charitable contributions of $250 on lines 1, 9a, and 13 (Code A), respectively.

She combines these amounts with similar items from other sources on her personal tax return. For example, if she has a $5,000 long-term capital loss from a stock transaction during the year, her overall net capital loss is $2,750. She then evaluates this net amount to determine the amount she may deduct on her Form 1040. ■

Thus, one must look at both page 1 and Schedule K to get complete information regarding a partnership's operations for the year.

The partnership reconciles book income with its tax return data on Schedule M–1 or Schedule M–3. This reconciliation is similar to the book-tax reconciliation prepared by a C corporation.

Schedule M–3 generally is required in lieu of Schedule M–1 if the partnership owns $10 million or more in assets at the end of the year. The net taxable income calculated on the Analysis of Net Income (Loss) schedule should agree with the reconciled taxable income on Schedule M–1 (line 9) or Schedule M–3. Schedule L

Bridge DISCIPLINE

Bridge to Financial Accounting

The equivalent in financial accounting to the partner's basis in his or her partnership interest is the **capital account**. A partner's ending balance in the capital account rarely is the same as his or her basis in the partnership interest. Just as the tax and accounting bases of a specific asset may differ, a partner's capital account and basis in the partnership interest usually are not equal.

Whereas contributions and most distributions from the partnership do not create financial accounting income, the capital account is "written up" or down to aggregate fair market value when the entity is formed. For most partnerships with simple financial transactions, *changes* to the capital account parallel closely the annual changes to the partner's basis in the partnership. Basis in one's partnership interest cannot be a negative number, but the capital account can become negative.

Oddly, the Schedules K–1 for the partners require an accounting for their capital accounts, but there is no required reconciliation for the partner's tax basis on the Schedule K–1. As a result, the tax adviser may find that a new partnership client has poor records with respect to the basis amounts of the partners, and a reconstruction must take place so that future computations will be correct. Sometimes, lacking adequate information with which to make this computation, the capital account is used because it is "close enough" and forms a good surrogate for the partner's basis in the partnership.

generally shows an accounting-basis balance sheet, and Schedule M–2 reconciles partners' beginning and ending capital accounts.

PARTNER'S OWNERSHIP INTEREST IN A PARTNERSHIP

Each partner typically owns both a **capital interest** and a **profits (loss) interest** in the partnership. A capital interest is measured by a partner's **capital sharing ratio**, which is the partner's percentage ownership of the capital of the partnership. A partner's capital interest can be determined in several ways. The most widely accepted method measures the capital interest as the percentage of net asset value (asset value remaining after payment of all partnership liabilities) a partner would receive on immediate liquidation of the partnership.

A profits (loss) interest is simply the partner's percentage allocation of current partnership operating results. **Profit and loss sharing ratios** usually are specified in the partnership agreement. They are used to determine each partner's allocation of partnership ordinary taxable income and separately stated items.[8] The partnership can change its profit and loss allocations at any time by amending the partnership agreement.

The partnership agreement may provide for a **special allocation** of certain items to specified partners, or it may allocate items in a different proportion from the general profit and loss sharing ratios. These items are reported separately to the partner receiving the allocation. For a special allocation to be recognized for tax purposes, it must produce nontax economic consequences to the partners receiving the allocation.[9]

EXAMPLE 3

When the George-Helen Partnership was formed, George contributed cash and Helen contributed some City of Iuka bonds that she had held for investment purposes. The partnership agreement allocates all of the tax-exempt interest income from the bonds to Helen as an inducement for her to remain a partner. This is an acceptable special allocation for income tax purposes; it reflects the differing economic circumstances that underlie the partners' contributions to the capital of the entity. Since Helen would have received the tax-exempt income if she had not joined the partnership, she can retain the tax-favored treatment via the special allocation. ■

[8] § 704(a).

[9] § 704(b).

Assume the same facts as in Example 5. Three years after it was formed, the George-Helen Partnership purchased some City of Butte bonds. The municipal bond interest income of $15,000 flows through to the partners as a separately stated item, so it retains its tax-exempt status. The partnership agreement allocates all of this income to George because he is subject to a higher marginal income tax rate than is Helen. The partnership then allocates $15,000 more of the partnership's ordinary income to Helen than to George. These allocations are not effective for income tax purposes because they have no purpose other than a reduction of the partners' combined income tax liability. ■

A partner has a **basis in the partnership interest**, just as he or she would have a tax basis in any asset owned. When income flows through to a partner from the partnership, the partner's basis in the partnership interest increases accordingly. When a loss flows through to a partner, basis is reduced.[10] A partner's basis is important when determining the treatment of distributions from the partnership to the partner, establishing the deductibility of partnership losses, and calculating gain or loss on the disposition of the partnership interest.

The Philly Clinic contributes $20,000 cash to acquire a 30% capital and profits interest in the Red Robin Partnership. In its first year of operations, the partnership earns ordinary income of $40,000 and makes no distributions to the partners. The Clinic's initial basis is the $20,000 that it paid for the interest. Philly recognizes ordinary income of $12,000 (30% × $40,000 partnership income) and increases its basis in Red Robin by the same amount, to $32,000. ■

The Code provides for increases and decreases in a partner's basis so that the income or loss from partnership operations is taxed only once. In Example 7, if the Philly Clinic sold its interest at the end of the first year for $32,000, it would have no gain or loss. If the Code did not provide for an adjustment of a partner's basis, Philly's basis would still be $20,000, and it would be taxed on the gain of $12,000 in addition to being taxed on its $12,000 share of income.

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.



11.2 Formation of a Partnership: Tax Effects

LO.2

Describe the tax effects of forming a partnership with cash and property contributions.

GAIN OR LOSS ON CONTRIBUTIONS TO THE PARTNERSHIP

When a taxpayer transfers property to an entity in exchange for valuable consideration, a taxable exchange usually results. Typically, both the taxpayer and the entity realize and recognize gain or loss on the exchange.[11] The gain or loss recognized by the transferor is the difference between the fair market value of the consideration received and the adjusted basis of the property transferred.[12]

In most situations, however, neither the partner nor the partnership recognizes the gain or loss that is realized when a partner contributes property to a partnership in exchange for a partnership interest. Instead, recognition of any realized gain or loss is deferred.[13]

There are two reasons for this nonrecognition treatment. First, forming a partnership allows investors to combine their assets toward greater economic goals than could be achieved separately. Only the form of ownership, rather than the amount owned by each investor, has changed. Requiring that gain be recognized on such

[10] §§ 705, 722, and 723.
[11] § 1001(c).
[12] § 1001(a).
[13] § 721.

transfers would make the formation of some partnerships economically unfeasible. Second, because the partnership interest received is typically not a liquid asset, the partner may not be able to generate the cash to pay the tax. Thus, deferral of the gain recognizes the economic realities of the business world and follows the wherewithal to pay principle.

EXAMPLE 8

Alicia transfers two assets to the Wren Partnership on the day the entity is created, in exchange for a 60% profits and loss interest worth $60,000. She contributes cash of $40,000 and retail display equipment (basis to her as a sole proprietor, $8,000; fair market value, $20,000). Since an exchange has occurred between two parties, Alicia *realizes* a $12,000 gain on this transaction. The gain realized is the fair market value of the partnership interest of $60,000 less the basis of the assets that Alicia surrendered to the partnership [$40,000 (cash) + $8,000 (equipment)].

Under § 721, Alicia *does not recognize* the $12,000 realized gain in the year of contribution. Alicia might not have had sufficient cash if she had been required to pay tax on the $12,000 gain. All that she received from the partnership was an illiquid partnership interest; she received no cash with which to pay any resulting tax liability. ■

EXAMPLE 9

Assume the same facts as in Example 8, except that the equipment Alicia contributes to the partnership has an adjusted basis of $25,000. She has a $5,000 *realized* loss [$60,000 − ($40,000 + $25,000)], but she cannot deduct the loss. Realized losses, as well as realized gains, are deferred by § 721.

Unless it was essential that the partnership receive Alicia's display equipment rather than similar equipment purchased from an outside supplier, Alicia should have considered selling the equipment to a third party. This would have allowed her to deduct a $5,000 loss in the year of the sale. Alicia then could have contributed $60,000 of cash (including the proceeds from the sale) for her interest in the partnership, and the partnership would have funds to purchase similar equipment. ■

EXAMPLE 10

Five years after the Wren Partnership (Examples 8 and 9) was created, Alicia contributes another piece of equipment to the entity. This property has a basis of $35,000 and a fair market value of $50,000. Alicia will defer the recognition of the $15,000 realized gain. Section 721 is effective *whenever* a partner makes a contribution to the capital of the partnership, not just when the partnership is formed. ■

EXCEPTIONS TO NONRECOGNITION

Contributions to the capital of a partnership or limited liability entity sometimes trigger recognized gain or loss. Realized gain or loss may be recognized when:

- the transaction is essentially a taxable exchange of properties;
- the transaction is a disguised sale of properties; or
- the partnership interest is received in exchange for services rendered to the partnership by the partner.[14]

Exchange

If a transaction is essentially a taxable exchange of properties, tax on the gain is not deferred under the nonrecognition provisions of § 721.[15]

EXAMPLE 11

Sara owns land, and Bob owns stock. Sara would like to have Bob's stock, and Bob wants Sara's land. If Sara and Bob both contribute their property to newly formed SB Partnership in exchange for interests in the partnership, the tax on the transaction appears to be deferred under § 721. The tax on a subsequent distribution by the partnership of the land to Bob and the stock to Sara also appears to be deferred under

[14] § 721(b). A few other exceptions to § 721 treatment also exist.

[15] Reg. § 1.731–1(c)(3).

§ 731. According to a literal interpretation of the statutes, no taxable exchange has occurred. Sara and Bob will find, however, that this type of tax subterfuge is not permitted. The IRS disregards the passage of the properties through the partnership and holds, instead, that Sara and Bob exchanged the land and stock directly. Thus, the transaction is treated as any other taxable exchange. ■

Disguised Sale

A similar result (i.e., recognition) occurs in a **disguised sale** of property or of a partnership interest. A disguised sale is deemed to occur when a partner contributes property to a partnership and soon thereafter receives a distribution from the partnership. This distribution could be viewed as a payment by the partnership for purchase of the property.[16]

EXAMPLE 17

Kim transfers property to the KLM Partnership. The property has an adjusted basis of $10,000 and a fair market value of $30,000. Two weeks later, the partnership makes a distribution of $30,000 of cash to Kim. Under the rules of § 731, the distribution would not be taxable to Kim if the basis for her partnership interest prior to the distribution was greater than the $30,000 of cash distributed. However, the transaction appears to be a disguised purchase-sale transaction, rather than a contribution and distribution. Therefore, Kim recognizes gain of $20,000 on transfer of the property, and the partnership is deemed to have purchased the property for $30,000. ■

A disguised sale is presumed to exist when a contribution by one partner is followed within two years by a specified distribution to him or her from the partnership.

Services

Another exception to the nonrecognition provision of § 721 occurs when a partner receives an interest in the partnership as compensation for services rendered to the partnership. This is not a tax-deferred transaction because services are not treated as "property" that can be transferred to a partnership on a tax-free basis. Instead, the partner performing the services recognizes ordinary compensation income equal to the fair market value of the partnership interest received.[17]

The partnership may deduct the amount included in the *service partner's* income if the services are of a deductible nature. If the services are not deductible by the partnership, they are capitalized. For example, architectural plans created by a partner are capitalized to the basis of a structure built with those plans. Alternatively, day-to-day management services performed by a partner for the partnership usually are deductible by the partnership.

EXAMPLE 18

Bill, Carol, and Dave form the BCD Partnership, with each receiving a one-third interest in the entity. Dave receives his one-third interest as compensation for the accounting and tax planning services he will render after the formation of the partnership. The value of a one-third interest in the partnership (for each of the parties) is $20,000. The partnership deducts $20,000 for Dave's services in computing ordinary income. Dave recognizes $20,000 of compensation income, and he has a $20,000 basis in his partnership interest. The same result would occur if the partnership had paid Dave $20,000 for his services and he immediately contributed that amount to the entity for a one-third ownership interest. ■

TAX ISSUES RELATED TO CONTRIBUTED PROPERTY

When a partner makes a tax-deferred contribution of an asset to the capital of a partnership, the entity assigns a *carryover basis* to the property.[18] The partnership's basis in the asset (the asset's "inside basis") is equal to the basis the partner held in the property

[16] § 707(a)(2)(B).
[17] § 83(a).
[18] § 723.

prior to its transfer to the partnership. The partner's basis in the new partnership interest (the owner's "outside basis") equals the prior basis in the contributed asset. The tax term for this basis concept is *substituted basis*. Thus, two assets are created out of one when a partnership is formed, namely, the property in the hands of the new entity and the new asset (the partnership interest) in the hands of the partner. Both assets are assigned a basis that is derived from the partner's basis in the contributed property.

The holding period of a partner's interest includes that of the contributed property when the property was a § 1231 asset or capital asset in the partner's hands. Otherwise, the holding period starts on the day the interest is acquired. The holding period of an interest acquired by a cash contribution starts at acquisition.

To understand the logic of these rules, consider what Congress was attempting to accomplish in this deferral transaction. For both parties, realized gain is deferred, under the wherewithal to pay concept, until the asset or ownership interest is subsequently disposed of in a taxable transaction. The deferral is accomplished through the use of a substituted basis by the partner and a carryover basis by the partnership. This treatment is similar to the treatment of assets transferred to a controlled corporation and the treatment of like-kind exchanges.[19]

EXAMPLE 10

On June 1, José transfers property to the JKL Partnership in exchange for a one-third interest in the partnership. The property has an adjusted basis to José of $10,000 and a fair market value of $30,000. José has a $20,000 realized gain on the exchange ($30,000 – $10,000), but he does not recognize any of the gain. José's basis for his partnership interest is the amount necessary to recognize the $20,000 deferred gain if his partnership interest is subsequently sold for its $30,000 fair market value. This amount, $10,000, is the substituted basis. The basis of the property contributed to the partnership is the amount necessary to allow for the recognition of the $20,000 deferred gain if the property is subsequently sold for its $30,000 fair market value. This amount, also $10,000, is the carryover basis. ■

The holding period for the contributed asset also carries over to the partnership. Thus, the partnership's holding period for the asset includes the period during which the partner owned the asset individually.

Depreciation Method and Period

If depreciable property is contributed to the partnership, the partnership usually is required to use the same cost recovery method and life as had been used by the partner. The partnership merely "steps into the shoes" of the partner and continues the same cost recovery calculations.

Intangible Assets

If a partner contributes an existing "§ 197" intangible asset to the partnership, the partnership generally will "step into the shoes" of the partner in determining future amortization deductions. Section 197 intangible assets include goodwill, going-concern value, information systems, customer- or supplier-related intangible assets, patents, licenses obtained from a governmental unit, franchises, trademarks, covenants not to compete, and other items.

Receivables, Inventory, and Losses

To prevent ordinary income from being converted into capital gain, gain or loss is treated as ordinary when the partnership disposes of either of the following.[20]

- Contributed receivables that were unrealized in the contributing partner's hands at the contribution date. Such receivables include the right to receive payment for goods or services.

[19] §§ 351 and 1031.

[20] § 724. For this purpose, § 724(d)(2) waives the holding period requirement in defining § 1231 property.

- Contributed property that was inventory in the contributor's hands on the contribution date, if the partnership disposes of the property within *five years of the contribution.* For this purpose, inventory includes all tangible property except capital and real or depreciable business assets.

EXAMPLE 15

Tyrone operates a cash basis retail electronics business as a sole proprietor. Ramon is an enterprising individual who likes to invest in small businesses. On January 2 of the current year, Tyrone and Ramon form the TR Partnership. Their partnership contributions are listed below.

	Adjusted Basis	Fair Market Value
From Tyrone		
Receivables	$ –0–	$ 20,000
Land used as parking lot*	12,000	50,000
Inventory	25,000	50,000
From Ramon		
Cash	120,000	120,000

*The parking lot had been held for nine months at the contribution date.

Within 30 days of formation, TR collects the receivables and sells the inventory for $50,000. It uses the land for the next 10 months as a parking lot, then sells it for $35,000. TR realized the following income in the current year from these transactions.

- Ordinary income of $20,000 from collecting the receivables.
- Ordinary income of $25,000 from the sale of inventory.
- § 1231 gain of $23,000 from the sale of land.

Since the land takes a carryover holding period, it is treated as having been held 19 months at the sale date. ■

A similar rule is designed to prevent a capital loss from being converted into an ordinary loss. Under the rule, if contributed property is disposed of at a loss and the property had a "built-in" capital loss on the contribution date, the loss is treated as a capital loss if the partnership disposes of the property *within five years of the contribution.* The capital loss is limited to the "built-in" loss on the date of contribution.[21]

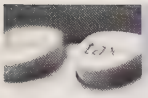
INSIDE AND OUTSIDE BASES

Reference has been made to the partnership's inside basis and the partners' outside basis. **Inside basis** refers to the adjusted basis of each partnership asset, as determined from the partnership's tax accounts. **Outside basis** represents each partner's basis in the partnership interest. Each partner "owns" a share of the partnership's inside basis for all its assets, and all partners should maintain a record of their respective outside bases.

In many cases—especially on formation of the partnership—the total of all the partners' outside bases equals the partnership's inside bases for all its assets. Differences between inside and outside basis arise when a partner's interest is sold to another person for more or less than the selling partner's share of the inside basis of partnership assets. The buying partner's outside basis equals the price paid for the interest, but the buyer's share of the partnership's inside basis is the same amount as the seller's share of the inside basis.

Concept Summary 11.1 reviews the rules that apply to partnership asset contributions and basis adjustments.

[21] § 724(c).



CONCEPT SUMMARY 11.1

Partnership Formation and Basis Computation

1. Generally, partners or partnerships do not recognize gain or loss when property is contributed for capital interests.
2. Partners contributing property for partnership interests take the contributed property's adjusted basis for their *outside basis* in their partnership interest. The partners are said to take a substituted basis in their partnership interest.
3. The partnership will continue to use the contributing partner's basis for the *inside basis* in property it receives. The contributed property is said to take a carryover basis.
4. The partnership's holding period for contributed property may include the contributing partner's holding period.
5. Gain is recognized by a contributing partner when services are contributed or when the capital contribution is a disguised sale or exchange.
6. Special rules may apply when the partnership disposes of contributed receivables, inventory, or loss assets.

LO.3

Determine the tax treatment of expenditures of a newly formed partnership and identify elections available to the partnership.

TAX ACCOUNTING ELECTIONS

A newly formed partnership must make numerous tax accounting elections. These elections are formal decisions on how a particular transaction or tax attribute should be handled. Most of these elections must be made by the partnership rather than by the partners individually.[22] The *partnership* makes the elections involving the following items.

- Inventory method.
- Cost or percentage depletion method, excluding oil and gas wells.
- Tax year and accounting method (cash, accrual, or hybrid).
- Cost recovery methods and assumptions.
- Treatment (i.e., deduction or credit) of research and experimentation costs.
- Amortization of organizational costs and amortization period.
- Amortization of startup expenditures and amortization period.
- First-year cost recovery deductions for certain tangible personal property.
- Nonrecognition treatment for gains from involuntary conversions.
- Cost allocation methods to compute the domestic production activities deduction.

Each partner is bound by the decisions made by the partnership relative to the elections. If the partnership fails to make an election, a partner cannot compensate for the error by making the election individually.

Though most elections are made by the partnership, each *partner* individually makes a specific election on the following relatively narrow tax issues.

- Whether to take a deduction or a credit for taxes paid to foreign countries.
- Whether to claim the cost or percentage depletion method for oil and gas wells.
- Whether to reduce the basis of depreciable property first when excluding income from discharge of indebtedness.

INITIAL COSTS OF A PARTNERSHIP

In its initial stages, a partnership incurs expenses relating to some or all of the following: forming the partnership (organizational costs), admitting partners to the

[22] § 703(b).

partnership, marketing and selling partnership units to prospective partners (**syndication costs**), acquiring assets, starting business operations (startup costs), negotiating contracts, and other items. Many of these expenditures are not currently deductible. However, the Code permits a deduction or ratable (straight-line) amortization of "organizational" and "startup" costs; acquisition costs incurred to acquire depreciable assets are included in the initial basis of the acquired assets; and costs related to some intangible assets may be amortized. "Syndication costs" may be neither amortized nor deducted.[23]

Organizational Costs

Organizational costs are incurred incident to the creation of the partnership and are capital in nature. Such costs include accounting and legal fees associated with the partnership formation.[24] Costs incurred for the following purposes are *not* organizational costs.

- Acquiring assets for the partnership.
- Transferring assets to the partnership.
- Admitting partners, other than at formation.
- Removing partners, other than at formation.
- Negotiating operating contracts.

A partnership may elect to deduct up to $5,000 of the costs in the year in which it begins business. This amount is reduced, however, by the organizational costs that exceed $50,000. Any organizational costs that cannot be deducted under this provision are amortizable over 180 months beginning with the month in which the partnership begins business.

The election to deduct organizational costs is made by entering the proper amounts on the first partnership return. Without a proper election, no deduction or amortization of the organizational costs is allowed until the partnership is liquidated.

The Bluejay Partnership, which was formed on March 1, 2010, incurs $52,000 in organizational costs. On its first tax return for the period March–December 2010, Bluejay can deduct $5,722 for these items. This deduction is the sum of:

- $5,000 reduced by the $2,000 ($52,000 − $50,000) amount by which the organizational costs exceed $50,000.
- $2,722 ($49,000 × 10/180) amortization of the remaining $49,000 ($52,000 − $3,000) of organizational costs for 10 months.

If Bluejay had failed to make a proper election to deduct or amortize the organizational costs, none of these costs would be deductible until the partnership liquidated. ■

Startup Costs

Operating costs that are incurred after the entity is formed but before it begins business are known as startup costs. Like organizational costs, startup costs are capitalized and may be immediately expensed and/or amortized.[25] Such costs include marketing surveys prior to conducting business, pre-operating advertising expenses, costs of establishing an accounting system, and salaries paid to executives and employees before the start of business.

A partnership may elect to deduct up to $5,000 of startup costs in the year in which it begins business. This amount is reduced, however, by the startup costs that exceed $50,000. Costs that are not deductible under this provision are amortizable over 180 months beginning with the month in which the partnership begins

[23] § 709(a).
[24] § 709(b)(2).
[25] § 195.

business. Without a proper election, no deduction or amortization of the startup costs is allowed until the partnership is liquidated.



In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

11.3 Operations of the Partnership

LO.4

Calculate partnership taxable income and describe how partnership items affect a partner's income tax return.

A key consideration in the taxation of partnerships is that a variety of entities can be partners and each may be affected differently by the partnership's operations. In particular, any combination of individuals, corporations, trusts, estates, or other partnerships may be partners. Furthermore, at the end of each year, every partner receives a share of the partnership's income, deductions, credits, and alternative minimum tax (AMT) preferences and adjustments.[26] These flow-through items ultimately may be reported and taxed on a wide variety of income tax returns [e.g., Forms 1040 (Individuals), 1041 (Fiduciaries), 1120 (C corporations), and 1120S (S corporations)], each facing different limitations and rules. Thus, the ultimate tax treatment of partnership operations is directly affected by how the partnership reports its operating results.

REPORTING OPERATING RESULTS

The measurement and reporting of partnership income require a two-step approach. Some items are not reported separately. These are netted at the partnership level and flow through to the partners as an aggregate number. Other items must be segregated and reported separately on the partnership return and each partner's Schedule K–1. Items passed through separately include the following.[27]

- Net short-term and net long-term capital gains or losses.
- Section 1231 gains and losses.
- Charitable contributions.
- Portfolio income items (qualified and ordinary dividends, interest, and royalties).
- Expenses related to portfolio income.
- Immediately expensed tangible personal property (§ 179).
- Data used by partners to compute their deduction for domestic production activities.[28]
- Items allocated differently from the general profit and loss ratio.
- Recovery of items previously deducted (tax benefit items).
- AMT preference and adjustment items.
- Self-employment income.
- Passive activity items (e.g., rental real estate income or loss).
- Intangible drilling and development costs.
- Taxes paid to foreign countries and U.S. possessions.

A partnership is not allowed the following deductions.

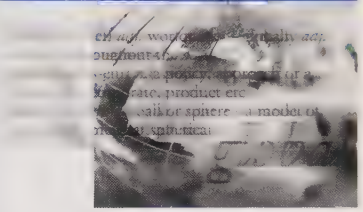
- Net operating loss.
- Dividends received deduction.

In addition, items that are allowed only to individuals, such as standard deductions or personal exemptions, are not allowed to the partnership.

[26] § 702(a).
[27] § 702(b).
[28] § 199.

Various Withholding Procedures Apply to Foreign Partners

GLOBAL *Tax Issues*



A U.S. partnership may have non-U.S. partners, and these owners are taxed on their share of the entity's U.S. income. Because it might be difficult for the IRS to collect the Federal income tax that is owed by such partners, several Code sections require the partnership to withhold and pay to the U.S. Treasury an amount relating to the non-U.S. partners.

If the partnership reports U.S. business income, withholding is required using the highest applicable Federal income tax rate. For instance, the withholding amount for a non-U.S. individual or corporate partner equals 35 percent of the owner's allocable share of the year's U.S. business income.

Gross income that relates to dividends, interest, rents, or other "fixed and determinable annual or periodic payments (FDAP)" generally is subject to withholding at a 30 percent rate. If a partnership sells U.S. real estate, the entity typically withholds 35 percent of the gain allocated to any non-U.S. partner.

Tax treaties can reduce these withholding tax rates or provide exceptions as to whether withholding is required at all.

EXAMPLE 17

Tiwanda is a one-third partner in the TUV Partnership. The partnership experienced a $20,000 net loss from operations last year, its first year of business. The partnership's transactions for this year are summarized below.

Fees received	$100,000
Salaries paid	30,000
Cost recovery deductions	10,000
Supplies, repairs	3,000
Payroll taxes paid	9,000
Contribution to art museum	6,000
Short-term capital gain	12,000
Passive income (rental operations)	7,500
Qualified dividends received	1,500
Tax-exempt income (bond interest)	2,100
AMT adjustment (private activity bond interest)	3,600
Payment of partner Vern's alimony obligations	4,000

The two-step computational process that is used to determine partnership income is applied in the following manner.

Nonseparately Stated Items (Ordinary Income)	
Fees received	$100,000
Salaries paid	(30,000)
Cost recovery deductions	(10,000)
Supplies, repairs	(3,000)
Payroll taxes paid	(9,000)
Ordinary income	$ 48,000
Separately Stated Items	
Contribution to art museum	$ 6,000
Short-term capital gain	12,000
Passive income (rental operations)	7,500
Qualified dividends received	1,500
Tax-exempt income (bond interest)	2,100
AMT adjustment (private activity bond interest)	3,600

CONCEPT SUMMARY 11.2

Tax Reporting of Partnership Activities

Event	Partnership Level	Partner Level
1. Compute partnership ordinary income.	Form 1065, line 22, page 1. Schedule K, Form 1065, line 1, page 4.	Schedule K–1 (Form 1065), line 1. Each partner's share is passed through for separate reporting. Each partner's basis is increased.
2. Compute partnership ordinary loss.	Form 1065, line 22, page 1. Schedule K, Form 1065, line 1, page 4.	Schedule K–1 (Form 1065), line 1. Each partner's share is passed through for separate reporting. Each partner's basis is decreased. The amount of a partner's loss deduction may be limited. Losses that may not be deducted are carried forward for use in future years.
3. Separately reported items like portfolio income, capital gain and loss, and § 179 deductions.	Schedule K, Form 1065, various lines, page 4.	Schedule K–1 (Form 1065), various lines. Each partner's share of each item is passed through for separate reporting.
4. Net earnings from self-employment.	Schedule K, Form 1065, line 14, page 4.	Schedule K–1 (Form 1065), line 14.

Each of the separately stated items passes through proportionately to each partner and is included on the appropriate schedule or netted with similar items that the partner generated for the year. Thus, in determining her tax liability, Tiwanda includes a $2,000 charitable contribution, a $4,000 short-term capital gain, $2,500 of passive rent income, $500 of qualified dividend income, and a $1,200 positive adjustment in computing alternative minimum taxable income. Tiwanda treats these items as if she had generated them herself. She must disclose her $700 share of tax-exempt interest on the first page of her Form 1040. In addition, Tiwanda reports $16,000 as her share of the partnership's ordinary income, the net amount of the nonseparately stated items.

The partnership is not allowed a deduction for last year's $20,000 net operating loss—this item was passed through to the partners in the previous year. Moreover, the partnership cannot deduct personal expenditures (payment of Vern's alimony). ■

Domestic Production Activities Deduction (§ 199)

As noted in Chapter 5, the conduct of certain businesses, usually manufacturing activities, can yield a domestic production activities deduction (DPAD). To determine the base for the deduction, domestic production gross receipts (DPGR) is computed. Then related cost of goods sold and direct and indirect expenses are subtracted to arrive at qualified production activities income (QPAI). The deduction (or DPAD) generally is 9 percent of the lesser of QPAI or taxable income.[29] When the taxpayer is not a corporation, modified AGI is substituted for taxable income. In no event, however, may the DPAD exceed 50 percent of the W–2 wages paid that are attributable to domestic production activities.[30]

When pass-through entities are involved (i.e., partnerships, S corporations, estates, and trusts), special rules apply.[31] Specifically, in the case of partnerships and

[29] § 199(a).
[30] § 199(b).
[31] The rules applicable to pass-through entities are contained in § 199(d)(1) and Reg. § 1.199–5.

limited liability entities, the following rules govern the DPAD computation and allowance.

- Whether an activity qualifies for the DPAD is determined at the entity level.
- Each partner is allocated its share of QPAI and W–2 wages related to domestic production activities. The appropriate amounts are listed on Schedule K–1 of Form 1065.
- The partner combines the partnership pass-through items with those from other sources (e.g., the partner operates a separate factory).
- The deduction then is computed at the partner level.
- Guaranteed payments made by a partnership to a partner are not W–2 wages for DPAD purposes.[32]

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.



Withdrawals

Capital withdrawals by partners during the year do not affect the partnership's income classification and reporting process.[33] These items usually are treated as distributions made on the last day of the partnership's tax year. In Example 17, the payment of Vern's alimony by the partnership is probably treated as a distribution from the partnership to Vern. Such distributions reduce the partner's outside basis by the amount of the cash received. The partnership's inside basis in assets is similarly reduced.

EXAMPLE 18

Bueno Company is a partner in the BB Partnership. The basis in Bueno's partnership interest is $10,000. The partnership distributes $3,000 cash to Bueno at the end of the year. Bueno does not recognize any gain on the distribution and reduces its basis in BB by $3,000 (the amount of the distribution) to $7,000. Bueno's basis in the cash received is $3,000, and the partnership's inside basis for its assets is reduced by the $3,000 cash distributed. ■

The result in Example 18 arises whether or not a similar distribution is made to other partners. In a partnership, all partners need not receive a pro rata distribution at the same time, as long as capital account balances are maintained appropriately.

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.



PARTNERSHIP ALLOCATIONS

Two key special allocation rules also can affect a partner's Schedule K–1 results.[34]

Economic Effect

The partnership agreement can provide that any partner may share capital, profits, and losses in different ratios.[35] For example, a partner could have a 25 percent capital sharing ratio, yet be allocated 30 percent of the profits and 20 percent of the losses of the partnership, or, as in Examples 5 and 6, a partner could be allocated a specific amount or items of income, deduction, gain, or loss. Such special allocations

[32]Reg. § 1.199–5(b)(1)(i).
[33]§ 731(a).
[34]The Code requires or allows certain other allocations not discussed here.
[35]§ 704(a).



Bridge to Business Law

Although a written partnership agreement is not required by most U.S. states, many rules governing the tax consequences to partners and their partnerships refer to such an agreement. Remember that a partner's distributive share of income, gain, loss, deduction, or credit is determined in accordance with the partnership agreement. Consequently, if taxpayers operating a business in partnership form want a measure of certainty as to the tax consequences of their activities, a carefully drafted partnership agreement is crucial. An agreement that sets forth the obligations, rights, and powers of the partners should prove invaluable in settling controversies among them and provide some degree of certainty as to the tax consequences of the partners' actions.

are permissible if they meet the **economic effect test.**[36] The rules prevent partners from shifting income and loss items merely to reduce current taxes.



In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

Precontribution Gain or Loss

Certain income, gain, loss, and deductions relative to contributed property may not be allocated under the economic effect rules.[37] Instead, **precontribution gain or loss** is allocated among the partners to take into account the variation between the basis of the property and its fair market value on the date of contribution.[38] For nondepreciable property, this means that *built-in* gain or loss on the date of contribution is allocated to the contributing partner when the property eventually is disposed of by the partnership in a taxable transaction.

EXAMPLE 19

Seth and Tim form the equal profit and loss sharing ST Partnership. Seth contributes cash of $10,000, and Tim contributes land purchased two years ago and held for investment. The land has an adjusted basis of $6,000 and fair market value of $10,000 at the contribution date. For accounting purposes, the partnership records the land at its fair market value of $10,000. For tax purposes, the partnership takes a carryover basis of $6,000 in the land. After using the land as a parking lot for five months, ST sells it for $10,600. No other transactions have taken place.

The accounting and tax gain from the land sale are computed as follows.

	Accounting	Tax
Amount realized	$ 10,600	$10,600
Less: Adjusted basis	(10,000)	(6,000)
Gain realized	$ 600	$ 4,600
Built-in gain to Tim	(–0–)	(4,000)
Remaining gain (split equally)	$ 600	$ 600

For tax purposes, Seth recognizes $300 of the gain ($600 remaining gain ÷ 2), and Tim recognizes $4,300 [$4,000 built-in gain + ($600 remaining gain ÷ 2)]. ■

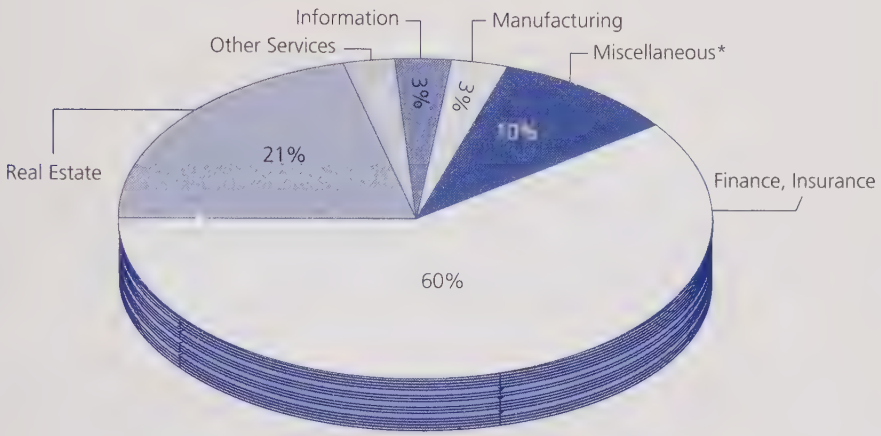
[36] Reg. § 1.704–1(b).
[37] § 704(b).
[38] § 704(c)(1)(A).

TAX

What Do Partnerships Do?

Partnerships report over $17 trillion in assets on their Form 1065 balance sheets. The partnership form seems to be especially popular for businesses operating in the financial services and real estate industries. Manufacturing assets tend not to be found as frequently in these entities.

Assets of Partnerships, Tax Year 2007



*"Miscellaneous" includes aggregated amounts from the agriculture, health care, construction, wholesale and retail trade, education, and arts and entertainment sectors.

BASIS OF A PARTNERSHIP INTEREST

LO.5

Determine a partner's basis in the partnership interest.

A partner's adjusted basis in a newly formed partnership usually equals (1) the adjusted basis in any property contributed to the partnership plus (2) the fair market value of any services the partner performed for the partnership (i.e., the amount of ordinary income reported by the partner for services rendered to the partnership).

A partnership interest also can be acquired after the partnership has been formed. The method of acquisition controls how the partner's initial basis is computed. If the partnership interest is purchased from another partner, the purchasing partner's basis is the amount paid (cost basis) for the partnership interest. The basis of a partnership interest acquired by gift is the donor's basis for the interest plus, in certain cases, some or all of the transfer (gift) tax paid by the donor. The basis of a partnership interest acquired through inheritance generally is the fair market value of the interest on the date the partner dies.

After the partnership begins its activities, or after a new partner is admitted to the partnership, the partner's basis is adjusted for numerous items. The following operating results *increase* a partner's adjusted basis.

- The partner's proportionate share of partnership income (including capital gains and tax-exempt income).
- The partner's proportionate share of any increase in partnership liabilities.

The following operating results *decrease* the partner's adjusted basis in the partnership. A partner's adjusted basis for the partnership interest cannot be reduced below zero.

- The partner's proportionate share of partnership deductions and losses (including capital losses).
- The partner's proportionate share of nondeductible expenses.
- The partner's proportionate share of any reduction in partnership liabilities.[39]

Increasing the adjusted basis for the partner's share of partnership taxable income is logical since the partner has already been taxed on the income. By increasing the partner's basis, this ensures that the partner is not taxed again on the income when he or she sells the interest or receives a distribution from the partnership.

It is also logical that tax-exempt income should increase the partner's basis. If the income is exempt in the current period, it should not contribute to the recognition of gain when the partner either sells the interest or receives a distribution from the partnership. Decreasing the adjusted basis for the partner's share of deductible losses, deductions, and noncapitalizable, nondeductible expenditures is done for the same reasons.

EXAMPLE 26

Yuri is a one-third partner in the XYZ Partnership. His proportionate share of the partnership income during the current year consists of $20,000 of ordinary taxable income and $10,000 of tax-exempt income. None of the income is distributed to Yuri. The adjusted basis of Yuri's partnership interest before adjusting for his share of income is $35,000, and the fair market value of the interest before considering the income items is $50,000.

The unrealized gain inherent in Yuri's investment in the partnership is $15,000 ($50,000 − $35,000). Yuri's proportionate share of the income items should increase the fair market value of the interest to $80,000 ($50,000 + $20,000 + $10,000). By increasing the adjusted basis of Yuri's partnership interest to $65,000 ($35,000 + $20,000 + $10,000), this ensures that the unrealized gain inherent in Yuri's partnership investment remains at $15,000.

Thus, $20,000 of ordinary taxable income is taxed to Yuri this year and should not be taxed again when Yuri either sells his interest or receives a distribution. Similarly, the tax-exempt income is exempt this year and should not increase Yuri's gain when he either sells his interest or receives a distribution from the partnership. ■

Partnership Liabilities

A partner's adjusted basis is affected by the partner's share of partnership debt.[40] Partnership debt includes most debt that is considered a liability under financial accounting rules except for accounts payable of a cash basis partnership and certain contingent liabilities.

Partnership debt is classified as either recourse or nonrecourse.[41] For **recourse debt**, the partnership or at least one of the partners is personally liable. This liability can exist, for example, through the operation of state law or through personal guarantees that a partner makes to the creditor. If the entity defaults on the loan, the lender can pursue the other assets of the borrower, including personal-use property.

For **nonrecourse debt**, no partner is personally liable. Lenders of nonrecourse debt generally require that collateral be pledged against the loan. Upon default, the lender can claim only the collateral, not the partners' personal assets.

EXAMPLE 27

The Bay Partnership financed its asset acquisitions with debt. If the partnership defaults on the debt, the lender can place a lien on the partners' salaries and personal assets. This constitutes recourse debt. ■

[39] §§ 705 and 752.
[40] § 752.
[41] Reg. § 1.752–1(a). All of the debts of an LLC generally are treated as nonrecourse debt for its members, because it is the entity, and not the members, that is ultimately liable for repayment.

The Tray Partnership financed its asset acquisitions with debt. If the partnership defaults on the debt, the lender can repossess the equipment purchased with the loan proceeds. This constitutes nonrecourse debt. ■

When Ray bought into the Sleigh Partnership, the entity was in the midst of settling litigation as to its liability to those who had purchased its products and were making warranty claims against the entity. Ray's basis in his partnership interest does not include his share of these contingent liabilities. ■

A partner's share of entity-level debt usually increases as a result of increases in outstanding partnership debt. This creates additional basis in the partnership for the partner, against which flow-through losses can be deducted.

Jim and Becky contribute property to form the JB Partnership. Jim contributes cash of $30,000. Becky contributes land with an adjusted basis and fair market value of $45,000, subject to a liability of $15,000. The partnership borrows $50,000 to finance construction of a building on the contributed land. At the end of the first year, the accrual basis partnership owes $3,500 in trade accounts payable to various vendors. No other operating activities occurred. If Jim and Becky share equally in liabilities, the partners' bases in their partnership interests are determined as follows.

Jim's Basis		Becky's Basis	
Contributed cash	$30,000	Basis in contributed land	$ 45,000
Share of debt on land (assumed by partnership)	7,500	Less: Debt assumed by partnership	(15,000)
Share of construction loan	25,000	Share of debt on land (assumed by partnership)	7,500
Share of trade accounts payable	1,750	Share of construction loan	25,000
		Share of trade accounts payable	1,750
Basis, end of Year 1	$64,250	Basis, end of Year 1	$ 64,250

In this case, it is reasonable that the parties have an equal basis after contributing their respective properties, because each is a 50% owner and they contributed property with identical net bases and identical *net* fair market values. ■

A decrease in a partner's share of partnership debt decreases the partner's basis. A partner's share of partnership debt decreases as a result of (1) decreases in total partnership debt and (2) assumption of a partner's debt by the entity. This limits the partner's ability to deduct current-year flow-through losses.

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.



PARTNER'S BASIS, GAIN, AND LOSS

The partner's basis is also affected by (1) postacquisition contributions of cash or property to the partnership and (2) postacquisition distributions of cash or property from the partnership.

Ed is a one-third member in the ERM LLC. On January 1, Ed's basis in his interest was $50,000. The calendar year, accrual basis entity generated ordinary taxable income of $210,000. It also received $60,000 of tax-exempt interest income from City of Buffalo bonds. It paid $3,000 in nondeductible fines and penalties.

On July 1, Ed contributed $20,000 cash and a computer (zero basis to him) to ERM. Ed's monthly draw from the LLC is $3,000; this is not a guaranteed payment. The only entity liabilities are trade accounts payable. On January 1, the trade accounts payable totaled $45,000; this account balance was $21,000 on December 31. Ed shares in one-third of the entity's liabilities for basis purposes.

Ed's basis in the LLC on December 31 is $115,000, computed as follows.

Beginning balance	$ 50,000
Share of ordinary income	70,000
Share of tax-exempt income	20,000
Share of nondeductible expenditures	(1,000)
Ed's basis in noncash capital contribution (computer)	–0–
Additional cash contributions	20,000
Capital withdrawal ($3,000 per month)	(36,000)
Share of net decrease in ERM liabilities [1/3 × ($45,000 – $21,000)]	(8,000)
Basis in the LLC interest	$115,000

■

EXAMPLE 26

Assume the same facts as in Example 25. If Ed withdraws cash of $115,000 from ERM the next year, the withdrawal is tax-free to him and reduces his basis to zero. The distribution is tax-free because Ed has recognized his share of net income throughout his association with the entity via the annual flow-through of his share of the ERM income and expense items to his personal tax return. Note that the $20,000 cash withdrawal of his share of the municipal bond interest retains its nontaxable character in this distribution. Ed receives the $20,000 tax-free because his basis was increased when ERM received the interest income. ■

Distributions

When a distribution involves something other than cash, the recipient partner (1) reduces the basis in the partnership interest and (2) assigns a basis to the asset received, both by the amount of the inside basis of the distributed asset. When cash and another asset are distributed at the same time, the partner first accounts for the cash received. Loss never is recognized when a partnership makes a distribution other than in its own liquidation. A partner recognizes gain only when receiving cash in an amount in excess of the basis in the partnership.

EXAMPLE 27

Pert Corporation has a $100,000 basis in the PQR Partnership. Pert receives a distribution from PQR in the form of a plot of land (basis to PQR of $40,000, fair market value of $50,000). Pert recognizes no income from the distribution. Pert's basis in the land is $40,000 (i.e., a carryover basis), and its basis in PQR now is $60,000 ($100,000 – $40,000). ■

EXAMPLE 28

Pert Corporation has a $100,000 basis in the PQR Partnership. Pert receives a distribution from PQR in the form of a plot of land (basis to PQR of $40,000, fair market value of $50,000), and $75,000 of cash.

Pert recognizes no gross income from the distribution because the cash received ($75,000) does not exceed Pert's partnership basis ($100,000). Pert's basis in the land is $25,000, the basis in PQR remaining after accounting for the cash ($100,000 partnership basis – $75,000 cash = $25,000 basis assigned to land). Pert's basis in the partnership now is zero ($25,000 basis after accounting for the cash – $25,000 assigned to the land). ■

EXAMPLE 29

Pert Corporation has a $100,000 basis in the PQR Partnership. Pert receives a distribution from PQR in the form of a plot of land (basis to PQR of $40,000, fair market value of $50,000), and $125,000 of cash. Pert recognizes $25,000 of gain from the distribution ($125,000 cash received – $100,000 basis in PQR). Pert's basis in the land is $0, as there

FIGURE 11.1 Partner's Basis in Partnership Interest

Basis generally is adjusted in the following order.

Initial basis. Amount paid for partnership interest, or gift or inherited basis (including share of partnership debt).

+ Partner's subsequent asset contributions.
+ Since interest acquired, partner's share of the partnership's:
  - Debt increase.
  - Income items.
  - Tax-exempt income items.
  - Excess of depletion deductions over adjusted basis of property subject to depletion.
– Partner's distributions and withdrawals.
– Since interest acquired, partner's share of the partnership's:
  - Debt decrease.
  - Nondeductible items not chargeable to a capital account.
  - Special depletion deduction for oil and gas wells.
  - Loss items.

The basis of a partner's interest never can be negative.

is no basis in PQR remaining after accounting for the cash. Pert's basis in the partnership also is zero. ■

Entity-level liabilities, and thus a partner's interest basis, change from day to day, but the partner's interest basis generally needs to be computed only once or twice a year. Figure 11.1 summarizes the rules for computing a partner's basis in a partnership interest.

Capital Changes

When a partnership interest is sold, exchanged, or retired, the partner must compute the adjusted basis as of the date the transaction occurs. The partner recognizes gain or loss on the disposition of the partnership interest, and this usually is a capital gain or loss. Income "bunching" may occur if the partner recognizes the pass-through of operating income in the same tax year during which the sale of the interest occurs. To the extent that the partner is allocated a share of ordinary income items that have yet to be recognized by the partnership (i.e., "hot assets"), some of the capital gain is converted to ordinary income.[42]

EXAMPLE 30

When its basis in the TUV Partnership is $100,000, taking into account all earnings to date and the sale-date liabilities of the partnership, Kurt Corporation sells its interest in the entity to Gloria for $120,000. Kurt recognizes a $20,000 capital gain [$120,000 (amount realized) – $100,000 (basis in partnership interest)]. ■

EXAMPLE 31

When its basis in the TUV Partnership is $100,000, taking into account all earnings to date and the sale-date liabilities of the partnership, Kurt Corporation sells its interest in the entity to Gloria for $120,000. At the time of the sale, Kurt's share of the TUV hot assets is $8,000. Kurt recognizes $8,000 of ordinary income and $12,000 of capital gain (i.e., the total gain of $20,000 is comprised of $8,000 of ordinary income and $12,000 of capital gain). ■

[42]Partnership items that hold unrecognized ordinary income are known as *hot assets*. Hot assets include the unrealized receivables of a cash basis partnership, and a broadly defined concept of appreciated inventory. §§ 751(a) and (d).

EXAMPLE 32

When its basis in the TUV Partnership is $100,000, taking into account all earnings to date and the sale-date liabilities of the partnership, Kurt Corporation sells its interest in the entity to Gloria for $120,000. At the time of the sale, Kurt's share of the TUV hot assets is $28,000. Kurt recognizes $28,000 of ordinary income and $8,000 of capital loss (i.e., the total gain of $20,000 is comprised of $28,000 of ordinary income and $8,000 of capital loss). ■

LO.6

Apply the limitations on deducting partnership losses.

LOSS LIMITATIONS

Partnership losses flow through to the partners for use on their tax returns. However, the amount and nature of the losses that may be used in a partner's tax computations may be limited. When limitations apply, all or a portion of the losses are suspended and carried forward until the rules allow them to be used. Only then can the losses decrease the partner's tax liability.

Three different limitations may apply to partnership losses that are passed through to a partner. The first allows the deduction of *losses* only to the extent the partner has adjusted basis for the partnership interest. Losses that are deductible under this basis limitation may then be subject to the *at-risk* limitations. Losses are deductible under this provision only to the extent the partner is at risk for the partnership interest. Any losses that survive this second limitation may be subject to a third limitation, the *passive* loss rules. Only losses that make it through all of these applicable limitations are eligible to be deducted on the partner's tax return.

EXAMPLE 33

Meg is a partner in a partnership that does not invest in real estate. On January 1, Meg's adjusted basis for her partnership interest is $50,000, and her at-risk amount is $35,000. Her share of losses from the partnership for the year is $60,000, all of which is passive. She has one other passive income-producing investment that produced $25,000 of passive income during the year. Meg can deduct $25,000 of partnership losses on her Form 1040.

Applicable Provision	Deductible Loss	Suspended Loss
Basis limitation	$50,000	$10,000
At-risk limitation	35,000	15,000
Passive loss limitation	25,000	10,000

Meg can deduct only $50,000 under the basis limitation. Of this $50,000, only $35,000 is deductible under the at-risk limitation. Under the passive loss limitation, passive losses can only be deducted against passive income. Thus, Meg can deduct only $25,000 on her return. The remaining $35,000 of losses is suspended. ■

Basis Limitation

A partner may deduct losses flowing through from the partnership only to the extent of the partner's adjusted basis in the partnership.[43] Losses that cannot be deducted because of this rule are suspended and carried forward (never back) for use against future increases in the partner's adjusted basis. Such increases might result from additional capital contributions, from sharing in additional partnership debts, or from future partnership income.

EXAMPLE 34

Carol and Dan do business as the CD Partnership, sharing profits and losses equally. All parties use the calendar year. At the start of the current year, the basis of Carol's partnership interest is $25,000. The partnership sustains an operating loss of $80,000 in the current year. Only $25,000 of Carol's $40,000 allocable share of the partnership loss can

[43] § 704(d).

be deducted under the basis limitation. As a result, the basis of Carol's partnership interest is zero as of January 1 of the following year, and Carol must carry forward the remaining $15,000 of partnership losses. ■

Assume the same facts as in Example 34, and that the partnership earns a profit of $70,000 for the next calendar year. Carol reports net partnership income of $20,000 ($35,000 distributive share of income − $15,000 carryforward loss). The basis of Carol's partnership interest becomes $20,000. ■

Tax Planning Strategies **MAKE YOUR OWN TAX SHELTER**

FRAMEWORK FOCUS: DEDUCTIONS

Strategy: Maximize Deductible Amounts.

In Example 34, Carol's entire $40,000 share of the current-year partnership loss could have been deducted under the basis limitation in the current year if she had contributed an additional $15,000 or more in capital by December 31. Alternatively, if the partnership had incurred additional debt by the end of the current year, Carol's basis might have been increased to permit some or all of the loss to be deducted in that year. Thus, if partnership losses are projected for a given year, careful tax planning can ensure their deductibility under the basis limitation. Note in the discussion below, however, that the effects of the at-risk and passive activity limitations also must be considered.

Figure 11.1 shows that contributions to capital, partnership income items, and distributions from the partnership are taken into account before loss items. This *losses last* rule can produce some unusual results in taxation of partnership distributions and deductibility of losses.

The Ellen-Glenn Partnership is owned equally by two partners: Ellen and the Glenn Hospital. At the beginning of the year, Ellen's basis in her partnership interest is $0. Her share of partnership income is $10,000 for the year, and she receives a $10,000 distribution from the partnership.

Under the basis adjustment ordering rules of Figure 11.1, Ellen's basis first is increased by the $10,000 of partnership income; then it is decreased by her $10,000 distribution. She reports her $10,000 share of partnership taxable income on her personal tax return. Her basis in the partnership at the end of the year is $0 ($0 + $10,000 income − $10,000 distribution). ■

Assume the same facts as in Example 36, except that Ellen's share of partnership operating results is a $10,000 loss instead of $10,000 income. She again receives a $10,000 distribution.

A distribution of cash in excess of basis in the partnership interest results in a gain to the distributee partner to the extent of the excess. Ellen's distribution is considered before the deductibility of the loss is evaluated under the basis limitation.

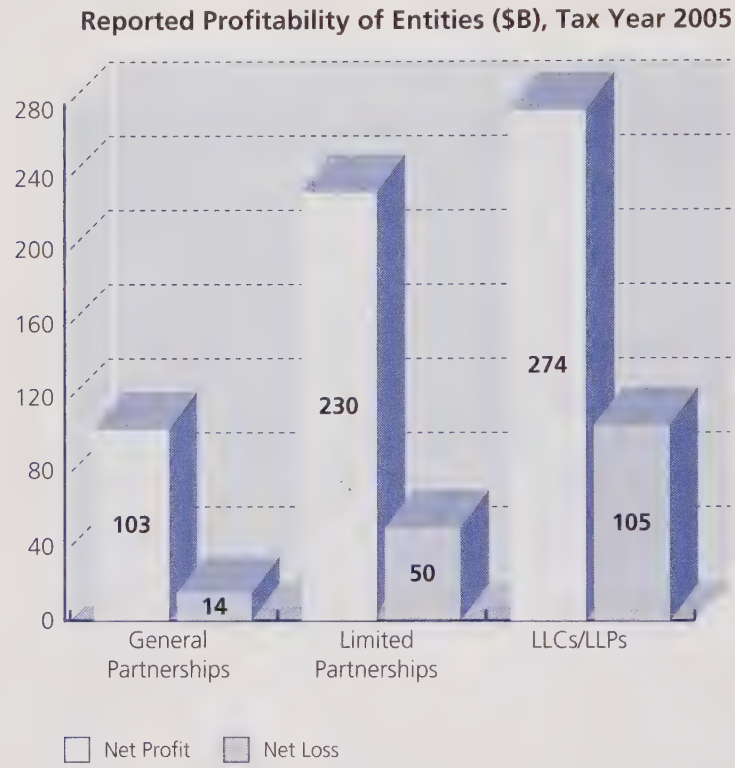
Therefore, Ellen recognizes gain on the $10,000 distribution because she has a $0 basis in her partnership interest. The gain effectively ensures that she still has a $0 basis after the distribution. The loss cannot be deducted under the basis limitation rule because Ellen has a $0 basis in her partnership interest. ■

Given this $20,000 difference in partnership earnings in the two examples ($10,000 income versus $10,000 loss), does Ellen's gross income differ in the same way? Actually, she reports $10,000 of income (gain) in each case: ordinary income in Example 36, and (probably) a capital gain from the distribution in Example 37. In

TAX

WHOSE MONEY ARE WE LOSING?

Net operating losses are more likely to be found in the limited partnership and LLC/LLP than in the general partnership.



Example 37, she also has a $10,000 suspended loss carryforward. These results are due solely to the basis adjustment ordering rules.

At-Risk Limitation

Under the at-risk rules, the partnership losses from business and income-producing activities that noncorporate partners and closely held C corporation partners can deduct are limited to amounts that are economically invested in the partnership. Invested amounts include the cash and the adjusted basis of property contributed by the partner and the partner's share of partnership earnings that has not been withdrawn.[44] A closely held C corporation exists when five or fewer individuals own more than 50 percent of the entity's stock under appropriate attribution and ownership rules.

When some or all of the partners are personally liable for partnership recourse debt, that debt is included in the adjusted basis of those partners. Usually, those partners also include the debt in their amount at risk.

[44] § 465(a).

No partner, however, carries any financial risk on nonrecourse debt. Therefore, as a general rule, partners cannot include nonrecourse debt in their amount at risk even though that debt is included in the adjusted basis of their partnership interest. This rule has an important exception, however. Real estate nonrecourse financing provided by a bank, retirement plan, or similar party or by a Federal, state, or local government generally is deemed to be at risk.[45] Such debt is termed **qualified nonrecourse debt**. Thus, an investor is deemed to be at risk for some nonrecourse debt.

EXAMPLE 38

Kelly invests $5,000 in the Kelly Green Limited Partnership as a 5% general partner. Shortly thereafter, the partnership acquires the master recording of a well-known vocalist for $250,000 ($50,000 from the partnership and $200,000 secured from a local bank via a *recourse* mortgage). Kelly's share of the recourse debt is $10,000, and her basis in the interest is $15,000 ($5,000 cash investment + $10,000 debt share). Since the debt is recourse, Kelly's at-risk amount also is $15,000. Kelly's share of partnership losses in the first year of operations is $11,000. Kelly can deduct the full $11,000 of partnership losses under both the basis and the at-risk limitations because this amount is less than both her outside basis and at-risk amount. ■

EXAMPLE 39

Assume the same facts as in Example 38, except the bank loan is nonrecourse. Kelly's basis in the partnership interest still is $15,000, but she can deduct only $5,000 of the flow-through loss. The amount she has at risk in the partnership does not include the nonrecourse debt. (The debt does not relate to real estate so it cannot be qualified nonrecourse debt.) ■

Passive Activity Rules

A partnership loss pass-through also may be disallowed under the passive activity rules. Recall from Chapter 6 that an activity is considered passive if the taxpayer (in this case, a partner) does not materially participate or if the activity is considered a rental activity. Losses from passive partnership activities are aggregated by each partner with his or her other passive income and losses. Any net passive loss is suspended and carried forward to future years, unless the partner also has generated net passive income for the tax year. Thus, the passive activity limitation applies at the partner level and is computed after the basis and at-risk limitations.

Tax Planning Strategies FORMATION AND OPERATION OF A PARTNERSHIP

FRAMEWORK FOCUS: INCOME AND EXCLUSIONS

Strategy: Postpone Recognition of Income to Achieve Tax Deferral.

In transferring assets to a partnership, potential partners should be cautious to ensure that they are not required to recognize any gain upon the creation of the entity. The nonrecognition provisions of § 721 are relatively straightforward and resemble the provisions under § 351. However, any partner can make a tax-deferred contribution of assets to the entity either at the inception of the partnership or later. This possibility is not available to less-than-controlling shareholders in a corporation.

The partners should anticipate the tax benefits and pitfalls that are presented in Subchapter K and should take appropriate actions to resolve any resulting problems. Typically, all that is needed is an appropriate provision in the partnership agreement (e.g., with respect to differing allocation percentages for gains and losses). Recall, however, that a special allocation of income, expense, or credit items in the partnership agreement must satisfy certain requirements before it is effective.

[45] § 465(b)(6).

11.4 Transactions between Partner and Partnership

LO.7

Use the tax laws regarding transactions between a partner and the partnership.

Many types of transactions occur between a partnership and its partners. A partner may contribute property to the partnership, perform services for the partnership, or receive distributions from the partnership. A partner may borrow money from or lend money to the partnership. Property may be bought and sold between a partner and the partnership. Several of these transactions were discussed earlier in the chapter. The remaining types of partner-partnership transactions are the focus of this section.

GUARANTEED PAYMENTS

If a partnership makes a payment to a partner in his or her capacity as a partner, the payment may be a draw against the partner's share of partnership income; a return of some or all of the partner's original capital contribution; or a guaranteed payment, among other treatments. A **guaranteed payment** is a payment for services performed by the partner or for the use of the partner's capital. The payment may not be determined by reference to partnership income. Guaranteed payments usually are expressed as a fixed-dollar amount or as a percentage of capital that the partner has invested in the partnership. Whether the partnership deducts or capitalizes the guaranteed payment depends on the nature of the payment.

EXAMPLE 40

David, Deepak, and Dale formed the accrual basis DDD Partnership. The partnership and each of the partners are calendar year taxpayers. According to the partnership agreement, David is to manage the partnership and receive a $21,000 distribution from the entity every year, payable in 12 monthly installments. Deepak is to receive an amount that is equal to 18% of his capital account, as it is computed by the firm's accountant at the beginning of the year, payable in 12 monthly installments. Dale is the partnership's advertising specialist. She withdraws about 3% of the partnership's net income every month for personal use. David and Deepak receive guaranteed payments from the partnership, but Dale does not. ■

Guaranteed payments resemble the salary or interest payments of other businesses and receive somewhat similar income tax treatment.[46] In contrast to the provision that usually applies to withdrawals of assets by partners from their partnerships, guaranteed payments are deductible (or capitalized) by the entity. Deductible guaranteed payments, like any other deductible expenses of a partnership, can create an ordinary loss for the entity. Partners receiving a guaranteed payment report ordinary income and treat it as paid on the last day of the entity's tax year.

EXAMPLE 41

Continue with the situation introduced in Example 40. For calendar year 2010, David receives the $21,000 as provided by the partnership agreement, Deepak's guaranteed payment is $17,000, and Dale withdraws $20,000 under the personal expenditures clause. Before considering these amounts, the partnership's ordinary income for the year is $650,000.

DDD can deduct its payments to David and Deepak, so the final amount of its ordinary income is $612,000 ($650,000 − $21,000 − $17,000). Thus, each of the equal partners is allocated $204,000 of ordinary partnership income ($612,000 ÷ 3). In addition, David reports the $21,000 guaranteed payment as income, and Deepak includes the $17,000 guaranteed payment in his gross income. Dale's partnership draw is

[46] § 707(c).

deemed to have come from the allocated $204,000 (or from the accumulated partnership income that was taxed to her in prior years) and is not taxed separately to her. ■

EXAMPLE 42

Assume the same facts as in Example 41, except that the partnership's tax year ends on March 31, 2011. The total amount of the guaranteed payments is taxable to the partners on that date. Thus, even though David received 9 of his 12 payments for fiscal 2011 in the 2010 calendar year, all of his guaranteed payments are taxable to him in 2011. Similarly, all of Deepak's guaranteed payments are taxable to him in 2011, rather than when they are received. The deduction for, and the gross income from, guaranteed payments is allowed on the same date that all of the other income and expense items relative to the partnership are allocated to the partners (i.e., on the last day of the entity's tax year). ■

OTHER TRANSACTIONS BETWEEN A PARTNER AND A PARTNERSHIP

Certain transactions between a partner and the partnership are treated as if the partner were an outsider, dealing with the partnership at arm's length.[47] Loan transactions, rental payments, and sales of property between the partner and the partnership are generally treated in this manner.

EXAMPLE 43

The Eastside Co-op, a one-third partner in the ABC Partnership, owns a tract of land that the partnership wishes to purchase. The land has a fair market value of $30,000 and an adjusted basis to Eastside of $17,000. If Eastside sells the land to the partnership, it recognizes a $13,000 gain on the sale, and the partnership takes a $30,000 cost basis in the land. If the land has a fair market value of $10,000 on the sale date, the Co-op recognizes a $7,000 loss. ■

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.



Sales of Property

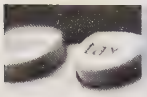
No loss is recognized on a sale of property between a person and a partnership when the person owns, directly or indirectly, more than 50 percent of partnership capital or profits.[48] The disallowed loss may not vanish entirely, however. If the person later sells the property at a gain, the disallowed loss reduces the gain that would otherwise be recognized.[49]

EXAMPLE 44

Barry sells land (adjusted basis, $30,000; fair market value, $45,000) to the BCD Partnership, of which he controls a 60% capital interest. The partnership pays him only $20,000 for the land. Barry cannot deduct his $10,000 realized loss. The sale apparently was not at arm's length, but the taxpayer's intentions are irrelevant. Barry and the partnership are related parties, and the loss is disallowed.

When BCD sells the land to an outsider at a later date, it receives a sales price of $44,000. The partnership can offset the recognition of its $24,000 realized gain on the subsequent sale ($44,000 sales proceeds − $20,000 adjusted basis) by the amount of the $10,000 prior disallowed loss ($20,000 − $30,000). Thus, BCD recognizes a $14,000 gain on its sale of the land. ■

[47] § 707(a).
[48] § 707(b).
[49] This is similar to treatment under § 267.



CONCEPT SUMMARY 11.3

Partner-Partnership Transactions

1. Partners can transact business with their partnerships in a nonpartner capacity. These transactions include the sale and exchange of property, rentals, loans of funds, etc.
2. A payment to a partner may be classified as a guaranteed payment if it is for services or use of the partner's capital and is not based on partnership income. A guaranteed payment usually is deductible by the partnership and is included in the partner's income on the last day of the partnership's tax year.
3. A payment to a partner may be treated as being to an outside (though related) party. Such a payment is deductible or capitalizable by the partnership at the time it must be included in income under the partner's method of accounting.
4. Guaranteed payments and payments to a partner that are treated as being to an outside party are deductible if the payment constitutes an ordinary and necessary (rather than capitalizable) business expense.
5. Losses are disallowed between a partner or related party and a partnership when the partner or related party owns more than a 50% interest in the partnership's capital or profits.
6. Income from a related-party sale is treated as ordinary income if the property is not a capital asset to both the transferor and the transferee.
7. Partners are not employees of their partnership, so the entity cannot deduct payments for partner fringe benefits, nor need it withhold or pay any payroll tax for payments to partners.

Using a similar rationale, any gain that is realized on a sale or exchange between a partner and a partnership in which the partner controls a capital or profits interest of more than 50 percent is recognized as ordinary income, unless the asset is a capital asset to both the seller and the purchaser.[50]

EXAMPLE 45

The Kent School purchases some land (adjusted basis, $30,000; fair market value, $45,000) for $45,000 from a partnership in which it controls a 90% profits interest. The land was a capital asset to the partnership. If Kent holds the land as a capital asset, the partnership recognizes a $15,000 capital gain. However, if the school also is a land developer and the property is not a capital asset to it, the partnership must recognize $15,000 of ordinary income from the sale, even though the property was a capital asset to the partnership. ■

PARTNERS AS EMPLOYEES

A partner usually does not qualify as an employee for tax purposes. For example, a partner receiving guaranteed payments is not regarded as an employee of the partnership for purposes of payroll taxes (e.g., FICA or FUTA). Moreover, since a partner is not an employee, the partnership cannot deduct its payments for the partner's fringe benefits. Nonetheless, a general partner's distributive share of ordinary partnership income and guaranteed payments for services generally are subject to the Federal self-employment tax.[51]



In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

[50] § 707(b)(2).

[51] § 1402(a).

Tax Planning Strategies TRANSACTIONS BETWEEN PARTNERS AND PARTNERSHIPS

FRAMEWORK FOCUS: DEDUCTIONS

Strategy: Maximize Deductible Amounts.

To ensure that no negative tax results occur, partners should be careful when engaging in transactions with the partnership. A partner who owns a majority of the partnership generally should not sell property at a loss to the partnership because the loss is disallowed. Similarly, a majority partner should not sell a capital asset to the partnership at a gain, if the asset is to be used by the partnership as other than a capital asset. The gain on this transaction is taxed as ordinary income to the selling partner rather than as capital gain.

As an alternative to selling property to a partnership, the partner may lease it to the partnership. The partner recognizes rent income, and the partnership has a rent expense. A partner who needs more cash immediately can sell the property to an outside third party; then the third party can lease the property to the partnership for a fair rental.

The timing of the deduction for payments by accrual basis partnerships to cash basis partners varies depending on whether the payment is a guaranteed payment. A deduction occurs when the partnership properly accrues the guaranteed payment. If the payment is treated as a payment to an outsider, the actual date the payment is made controls the timing of the deduction.

11.5 LIMITED LIABILITY ENTITIES

LO.8

Apply partnership tax law provisions to limited liability companies (LLCs) and limited liability partnerships (LLPs).

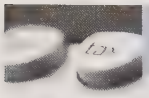
LIMITED LIABILITY COMPANIES

The *limited liability company (LLC)* combines partnership taxation with limited personal liability for all owners of the entity. All states and the District of Columbia have passed legislation permitting the establishment of LLCs.

Taxation of LLCs

A properly structured LLC is taxed as a partnership. Because LLC members are not personally liable for the debts of the entity, the LLC effectively is treated as a limited partnership with no general partners. This may result in an unusual application of partnership taxation rules. The IRS has not specifically ruled on most aspects of LLC taxation, so several of the following comments are based on speculation about how a partnership with no general partners would be taxed.

- Formation of a new LLC is treated in the same manner as formation of a partnership. Generally, no gain or loss is recognized by the LLC member or the LLC, the member takes a substituted basis in the LLC interest, and the LLC takes a carryover basis in the assets it receives.
- An LLC's income and losses are allocated proportionately. Special allocations are permitted, as long as they demonstrate economic effect.
- An LLC member contributing property with built-in gains can be subject to tax on certain distributions within seven years of the contribution.
- A loss must meet the basis, at-risk, and passive loss limitations to be currently deductible. Because debt of an LLC is considered nonrecourse to each of the members, it is not included in the at-risk limitation unless it is "qualified nonrecourse financing."
- The initial accounting period and accounting method elections are available to an LLC.
- Property takes a carryover or substituted basis when distributed from an LLC.



CONCEPT SUMMARY 11.4

Advantages and Disadvantages of the Partnership Form

The partnership form may be attractive when one or more of the following factors is present.

- The entity is generating net taxable losses and/or valuable tax credits, which will be of use to the owners.
- The owners want to avoid complex corporate administrative and filing requirements.
- Other means of reducing the effects of the double taxation of corporate business income (e.g., compensation to owners, interest, and rental payments) have been exhausted.
- The entity does not generate material amounts of tax preference and adjustment items, which increase the alternative minimum tax liabilities of its owners.
- The entity is generating net passive income, which its owners can use to claim immediate deductions for net passive losses that they have generated from other sources.
- The owners wish to make special allocations of certain income or deduction items that are not possible under the C or S corporation forms.
- The owners hold adequate bases in their ownership interests to facilitate the deduction of flow-through losses and the assignment of an adequate basis to assets distributed in kind to the owners.

The partnership form may be less attractive when one or more of the following factors is present.

- The tax paid by the owners on the entity's income is greater than that payable by the entity as a C corporation, and the income is not expected to be distributed soon. (If distributed by a C corporation, double taxation would likely occur.)
- The entity is generating net taxable income without distributing any cash to the owners. The owners may not have sufficient cash with which to pay the tax on the entity's earnings.
- The type of income that the entity is generating (e.g., business and portfolio income) is not as attractive to its owners as net passive income would be, because the owners could use net passive income to offset the net passive losses that they have generated on their own.
- The entity is in a high-exposure business, and the owners desire protection from personal liability. An LLC, LLP, or LLLP structure may be available, however, to limit personal liability.
- The owners want to avoid Federal self-employment tax.
- Partnership operations are complex (indicating that Form 1065 might not be filed until near the due date for the return), but partners with the same tax year need to file their returns as early as possible for personal reasons (e.g., to meet debt requirements or to receive a tax refund).

Advantages of an LLC

An LLC offers certain advantages over a limited partnership.

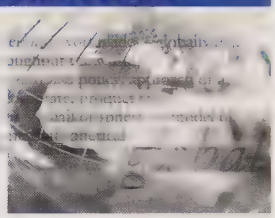
- Generally, none of the members of an LLC is personally liable for the entity's debts. In contrast, general partners in a limited partnership have personal liability for partnership recourse debts.
- Limited partners cannot participate in the management of a partnership. All owners of an LLC have the legal right to participate in the entity's management.

An LLC also offers certain advantages over an S corporation (see Chapter 12), including the following.

- An LLC can have an unlimited number of owners, while an S corporation is limited to 100 shareholders.

PARTNERSHIPS AROUND THE WORLD

GLOBAL
Tax Issues



Technology continues to act as a catalyst—and incentive—for the creation of joint ventures. From Web kiosks at gas stations to global satellite networks, high-tech companies are forging alliances to bring technology to consumers.

Microsoft has teamed up with BP to provide news, weather, and other content for customers to watch while they fill up at the gas station. Time Warner and Radiant Systems, Inc., formed their own venture to offer programming at other gas stations, pizza parlors, and numerous other retail outlets. These ventures appear to be spurred by a desire to capture larger shares of the ever-expanding global market.

Meanwhile, various domestic communications companies are continuing to align themselves with partners in non-U.S. markets; each wants to have the widest possible service coverage area so it can offer efficient networking to business clients with a global presence.

- Any taxpayers, including corporations, nonresident aliens, other partnerships, and trusts, can be owners of an LLC. S corporation shares can be held only by specified parties.
- The transfer of property to an LLC in exchange for an ownership interest in the entity is governed by partnership tax provisions rather than corporate tax provisions. Thus, the transfers need not satisfy the 80 percent control requirement needed for tax-free treatment under the corporate tax statutes.
- The S corporation taxes on built-in gains and passive income do not apply to LLCs.
- An owner's basis in an LLC includes the owner's share of almost all LLC liabilities under § 752. Only certain entity liabilities are included in the S corporation shareholder's basis.
- An LLC may make special allocations, whereas S corporations must allocate income, loss, etc., only on a per share/per day basis.

Disadvantages of an LLC

There is only a limited body of case law interpreting the various state statutes, so the application of specific provisions in a specific state may be uncertain. An additional uncertainty for LLCs that operate in more than one jurisdiction pertains to which state's law will prevail and how it will be applied.

Among other factors, statutes differ from state to state as to the type of business an LLC can conduct—primarily the extent to which a service-providing firm can operate as an LLC.

Despite these uncertainties and limitations, LLCs are being formed at increasing rates, and the ranks of multistate LLCs also are rising quickly.

LIMITED LIABILITY PARTNERSHIPS

The difference between a general partnership and a limited liability partnership (LLP) is small, but very significant. General partners are jointly and severally liable for all partnership debts. Partners in an LLP are jointly and severally liable for commercial debt. They also are personally liable for their own malpractice or other torts. They are not, however, personally liable for the malpractice and torts of their partners. As a result, the exposure of their personal assets to lawsuits filed against other partners and the partnership is considerably reduced.

11.6 Summary

Partnerships and LLCs are popular among business owners because formation of the entity is relatively simple and tax-free. The Code places very few restrictions on who can be a partner. Partnerships are especially attractive when operating losses are anticipated, or when marginal rates that would apply to partnership income are less than those that would be paid by a C corporation. Partnerships do not offer the limited liability of a corporate entity, but the use of limited partnerships, LLCs, LLPs, and LLLPs can offer some protection to the owners.

Partnerships are tax-reporting, not taxpaying, entities. Distributive shares of ordinary income and separately stated items are taxed to the partners on the last day of the tax year. Special allocations and guaranteed payments are allowed and offer partners the ability to tailor the cash-flow and taxable amounts that are distributed by the entity to its owners. Deductions for flow-through losses may be limited by the related-party, passive activity, and at-risk rules, as well as by the partner's interest basis. The flexibility of the partnership rules makes this form continually attractive to new businesses, especially in a global setting.

REFOCUS ON THE BIG PICTURE

THE TAX CONSEQUENCES OF PARTNERSHIP FORMATION AND OPERATIONS

When a partnership is formed, no tax generally results to the partnership or to any of the contributing partners. Walter has no tax consequences on the $600,000 of realized gain when he contributes property to the partnership. Similarly, Grace is not taxed on the $250,000 of precontribution gain relating to the construction equipment. The partnership takes a carryover basis in the properties (land, improvements, and equipment). If any of the land improvements are depreciable, the partnership steps into Walter's shoes in calculating depreciation deductions.

The tax-deferred nature of partnership formation has its limits. Since Frank receives his partnership interest in exchange for services he performed, it is currently taxable to him. The partnership either capitalizes or expenses the cost of the services, depending on their nature.

On an ongoing basis, it is perfectly acceptable for the partnership to allocate 25 percent of the profits and cash flows to Frank, provided the allocations have substantial economic effect. Essentially, this means that everything must "even out" in the end.

The precontribution gains for the land, improvements, and equipment must be tracked. Any realized and recognized gains or depreciation expense related to these precontribution gains are allocated to ensure that the contributing partner eventually recognizes the effect of the built-in gain.

What If?

What happens in the future when the partners decide to expand or renovate the facilities? At that time, the existing partners can contribute additional funds, the partnership can obtain new partners, or the entity can borrow money. A partnership is not subject to the 80 percent control requirement applicable to the formation of a corporation and subsequent transfers to it. Therefore, new investors can contribute cash or other property in exchange for interests in the partnership—and the transaction will qualify for tax-deferred treatment.

SUGGESTED READINGS

Paul D. Carman and Colleen A. Kushner, "Partner Classification for Tax Purposes," *Journal of Taxation*, September 2008.

C. Hennig, W. Raabe, and J. Everett, "Schedule M–3 for Partnerships," *TAXES*, October 2007.

Patrick H. Smith, "Taxation by States of Single-Member LLCs," *Business Entities*, September/October 2007.

Michael G. Stevens, "After *Garnett*, *Thompson*, and *Hegarty*: LLC Members' Losses No Longer Presumed Passive?" *Business Entities*, January 2010.

KEY TERMS

Basis in the partnership interest, 11–9
Capital account, 11–8
Capital interest, 11–8
Capital sharing ratio, 11–8
Disguised sale, 11–11
Economic effect test, 11–20
General partnership, 11–5
Guaranteed payment, 11–30
Inside basis, 11–13
Limited liability company (LLC), 11–5
Limited liability limited partnership (LLLP), 11–5
Limited liability partnership (LLP), 11–5
Limited partnership, 11–5
Nonrecourse debt, 11–22
Organizational costs, 11–15
Outside basis, 11–13
Precontribution gain or loss, 11–20
Profit and loss sharing ratios, 11–8
Profits (loss) interest, 11–8
Qualified nonrecourse debt, 11–29
Recourse debt, 11–22
Separately stated items, 11–6
Special allocation, 11–8
Syndication costs, 11–15

PROBLEMS

1. **LO.2, 4** Bobbi and Carl plan to form the BC Partnership, in which each partner will own a 50% interest. Bobbi will contribute appreciated land, and Carl will contribute cash. What is the tax effect of the formation to Bobbi, Carl, and the partnership? **ISSUE ID**

2. **LO.2** Chip and Marty form an equal partnership with a cash contribution of $200,000 from Chip and a property contribution (adjusted basis of $100,000 and a fair market value of $200,000) from Marty.
   a. How much gain, if any, does Chip recognize on the transfer? Must Marty recognize any gain?
   b. What is Chip's basis in his partnership interest?
   c. What is Marty's basis in his partnership interest?
   d. What basis does the partnership take in the property transferred by Marty?

3. **LO.2** Tom and Liz form an equal partnership with a $60,000 cash contribution from Tom and a contribution of property (basis of $75,000, fair market value of $60,000) from Liz. **DECISION MAKING**
   a. Compute Liz's realized and recognized gain or loss from the contribution.
   b. Compute Tom's basis in his partnership interest.
   c. Compute Liz's basis in her partnership interest.
   d. What basis does the partnership take in Liz's contributed asset?
   e. Are there more tax-effective ways to structure the transaction?

4. **LO.2, 4** Justin and Tiffany form the equal TJ Partnership. Justin contributes cash of $20,000 and land (fair market value of $80,000, adjusted basis of $65,000), and Tiffany contributes the assets of her sole proprietorship (value of $100,000, adjusted basis of $125,000). What are the tax consequences of the partnership formation to Justin, Tiffany, and TJ Partnership? **ISSUE ID**

5. **LO.2, 3** Block, Inc., a calendar year general contractor, and Strauss, Inc., a development corporation with a July 31 year-end, formed the equal SB LLC on January 1 of the current year. Both LLC members are C corporations. The LLC was formed to construct and lease shopping centers in Wilmington, Delaware. Block contributed equipment (basis of $650,000, fair market value of $650,000), building permits, and architectural designs created **ISSUE ID**

by Block's employees (basis $0, fair market value $100,000). Strauss contributed land (basis $50,000, fair market value $250,000) and cash of $500,000. The cash was used as follows.

Legal fees for drafting the LLC articles of organization	$ 10,000
Materials and labor costs for construction in progress on shopping center	400,000
Office expenses (utilities, rent, overhead, etc.)	90,000

What issues must the LLC address in preparing its initial tax return?

DECISION MAKING

6. **LO.2, 5** Beth and Ben are equal members of the BB Partnership, formed on June 1 of the current year. Ben contributed land that he inherited from his father three years ago. Ben's father purchased the land in 1950 for $6,000. The land was worth $50,000 when Ben's father died. The fair market value of the land was $75,000 at the date it was contributed to the partnership.

   Beth has significant experience developing real estate. After the partnership is formed, she will prepare a plan for developing the property and secure zoning approvals for the partnership. She would normally bill a third party $25,000 for these efforts. Beth will also contribute $50,000 of cash in exchange for her 50% interest in the partnership. The value of her 50% interest is $75,000.

   a. How much gain or income does Ben recognize on his contribution of the land to the partnership? What is the character of any gain or income recognized?
   b. What basis does Ben take in his partnership interest?
   c. How much gain or income will Beth recognize on the formation of the partnership? What is the character of any gain or income recognized?
   d. What basis will Beth take in her partnership interest?
   e. Construct an opening balance sheet for the partnership reflecting the partnership's basis in the assets and the fair market value of these assets.
   f. Outline any planning opportunities that may minimize current taxation to any of the parties.

7. **LO.2** Continue with the facts presented in Problem 6. At the end of the first year, the partnership distributes $50,000 cash to Ben. No distribution is made to Beth.
   a. How does Ben treat the payment?
   b. How much income or gain would Ben recognize as a result of the payment?
   c. Under general tax rules, what basis would the partnership take in the land Ben contributed?

8. **LO.5** Describe the tax treatment of a proportionate nonliquidating distribution of cash, land, and inventory. How are the partner's basis in the property received and the partner's gain or loss on the distribution determined? What are the tax effects to the partnership?

ISSUE ID

9. **LO.2, 5** The SueBart LLC distributes the following assets to its member, Bart.

   - $10,000 cash.
   - An account receivable with a $10,000 value and a $0 basis to the entity.
   - A parcel of land with a $10,000 value and a $2,000 basis to the entity.

   What issues must be considered in determining the Federal income tax treatment of the distribution?

10. **LO.3** On July 1 of the current year, the R&R Partnership was formed to operate a bed and breakfast inn. The partnership paid $3,000 in legal fees for drafting the partnership agreement, and $5,000 for accounting fees related to organizing the entity. It also paid $10,000 in syndication costs to locate and secure investments from limited partners. In addition, before opening the inn for business, the entity paid $15,500 for advertising and $36,000 in costs related to an open house just before the grand opening of the property. The partnership opened the inn for business on October 1.
    a. How are these expenses classified?
    b. How much may the partnership deduct in its initial year of operations?
    c. How are costs treated that are not deducted currently?

11. **LO.2, 4** Phoebe and Parker are equal members of the Phoenix Partnership. They are real estate investors who formed the partnership several years ago with equal cash contributions. Phoenix then purchased a piece of land.

On January 1 of the current year, to acquire a one-third interest in the entity, Reece contributed some land she had held for investment to the partnership. Reece purchased the land five years ago for $75,000; its fair market value at the contribution date was $90,000. No special allocation agreements were in effect before or after Reece was admitted to the partnership. Phoenix holds all land for investment.

Immediately before Reece's property contribution, the Phoenix balance sheet was as follows.

	Basis	FMV		Basis	FMV
Land	$30,000	$180,000	Phoebe, capital	$15,000	$90,000
			Parker, capital	15,000	90,000
	$30,000	$180,000		$30,000	$180,000

a. At the contribution date, what is Reece's basis in her interest in Phoenix?
b. When does the partnership's holding period begin for the contributed land?
c. On June 30 of the current year, the partnership sold the land contributed by Reece for $90,000. How much is the recognized gain or loss, and how is it allocated among the partners?
d. Prepare a balance sheet reflecting basis and fair market value for the partnership immediately after the land sale.

12. **LO.4** Assume the same facts as in Problem 11, with the following exceptions.

- Reece purchased the land five years ago for $120,000. Its fair market value was $90,000 when it was contributed to the partnership.
- Phoenix sold the land contributed by Reece for $84,000.

a. How much is the recognized gain or loss, and how is it allocated among the partners?
b. Prepare a balance sheet reflecting basis and fair market value for the partnership immediately after the land sale. Complete schedules that support the amount in each partner's capital account.

13. **LO.4, 5** Erica and Greg are equal partners in the accrual basis EG Partnership. At the beginning of the current tax year, Erica's capital account has a balance of $120,000, and the partnership has recourse debts of $80,000 payable to unrelated parties. All partnership recourse debt is shared equally between the partners. The following information about EG's operations for the current year is obtained from the partnership's records.

Taxable income	$140,000
Interest income from City of Huntsville bond	2,000
§ 1231 gain	4,000
Short-term capital loss	3,000
Political contribution	1,000
Charitable contribution to Red Cross	2,000
Cash distribution to Erica	10,000

Year-end partnership debt payable to unrelated parties is $100,000. If all transactions are reflected in her beginning capital and basis in the same manner:

a. What is Erica's basis in the partnership interest at the beginning of the year?
b. What is Erica's basis in the partnership interest at the end of the current year?

14. **LO.1, 2** Carol and Connie formed the equal CC Partnership on January 1. Carol contributed $30,000 cash, and land with a fair market value of $60,000 and an adjusted basis of $40,000. Connie contributed equipment with a fair market value of $90,000 and an adjusted basis of $30,000. Connie previously had used the equipment in a sole proprietorship. As to the partnership formation:

a. How much gain or loss will Carol, Connie, and the partnership realize?
b. How much gain or loss will Carol, Connie, and the partnership recognize?

c. What bases will Carol and Connie take in their partnership interests?
d. What bases will CC take in the assets it receives?
e. Are there any differences between inside and outside basis at this point?
f. How will the partnership depreciate any assets it receives from the partners?

DECISION MAKING

COMMUNICATIONS

15. **LO.4, 5, 6** Your client, the Williams Institute of Technology (WIT), is a widely held C corporation and is not subject to the passive loss limitations. WIT is a 60% partner in the Research Industries Partnership (RIP). WIT is located at 76 Bradford Lane, St. Paul, MN 55164. The controller, Jeanine West, has sent you the following note and a copy of WIT's 2009 Schedule K–1 from the partnership.

Excerpt from client's note
RIP expects its 2010 operations to include the following.

Net loss from operations	$200,000
Capital gain from sale of land	100,000

The land was contributed by DASH, the other partner, when its value was $260,000. The partnership sold the land for $300,000. The partnership used this cash to repay all the partnership debt and pay for research and development expenditures, which a tax partner in your firm has said RIP can deduct this year.

We want to be sure we can deduct our full share of this loss, but we do not believe we will have enough basis to do so.

Items Reported on the 2009 Schedule K–1	
WIT's share of partnership recourse liabilities	$90,000
WIT's ending capital account balance	30,000

Draft a letter to the WIT controller that describes the following.

- WIT's allocation of partnership items.
- WIT's basis in the partnership interest following the allocation.
- Any limitations on loss deductions.
- Any recommendations you have that would allow WIT to claim the full amount of losses in 2010.

WIT's 2009 Schedule K–1 accurately reflects the information needed to compute its basis in the partnership interest. The research expenditures are fully deductible this year, as the partner said.

Your client has experience researching issues in the Internal Revenue Code, so you may use some citations. However, be sure that the letter is written in layperson's terms and that legal citations are minimized.

16. **LO.2** Lee, Brad, and Rick form the LBR Partnership on January 1 of the current year. In return for a 25% interest, Lee transfers property (basis of $15,000, fair market value of $17,500) subject to a nonrecourse liability of $10,000. The liability is assumed by the partnership. Brad transfers property (basis of $16,000, fair market value of $7,500) for a 25% interest, and Rick transfers cash of $15,000 for the remaining 50% interest.
a. How much gain must Lee recognize on the transfer?
b. What is Lee's basis in his interest in the partnership?
c. How much loss may Brad recognize on the transfer?
d. What is Brad's basis in his interest in the partnership?
e. What is Rick's basis in his interest in the partnership?
f. What basis does the LBR Partnership take in the property transferred by Lee?
g. What is the partnership's basis in the property transferred by Brad?

CRITICAL THINKING

17. **LO.2** Assume the same facts as in Problem 16, except that the property contributed by Lee has a fair market value of $27,500 and is subject to a nonrecourse mortgage of $20,000.
a. What is Lee's basis in his partnership interest?
b. How much gain must Lee recognize on the transfer?

c. What is Brad's basis in his partnership interest?
d. What is Rick's basis in his partnership interest?
e. What basis does the LBR Partnership take in the property transferred by Lee?

18. **LO.2, 4, 5** Sam has operated a microbrewery (sole proprietorship) in southern Oregon for the past 15 years. The business has been highly profitable lately, and demand for the product will soon exceed the amount Sam can produce with his present facilities. Marcie, a long-time fan of the brewery, has offered to invest $1,500,000 for equipment to expand production. The assets and goodwill of the brewery are currently worth $1,000,000 (tax basis is only $200,000). Sam will continue to manage the business. He is not willing to own less than 50% of whatever arrangement they arrive at. What issues should Sam and Marcie address and document before finalizing their venture?

ISSUE ID

19. **LO.5, 6** The BCD Partnership plans to distribute cash of $20,000 to partner Brad at the end of the tax year. The partnership reported a loss for the year, and Brad's share of the loss is $10,000. Brad has a basis of $15,000 in the partnership interest, including his share of partnership liabilities. The partnership expects to report substantial income in future years.
a. What rules are used to calculate Brad's ending basis in his partnership interest?
b. How much income or loss must Brad report for the tax year?
c. Will the deduction for any of the $10,000 loss be suspended?
d. Could any planning opportunities be used to minimize the tax ramifications of the distribution?

ISSUE ID

DECISION MAKING

20. **LO.2, 3** The Heron Partnership was formed on July 1 of the current year and admitted Carl and Megan as equal partners on that date. The partners contributed $200,000 cash each to establish a children's clothing store in the local mall. The partners spent July and August buying inventory, equipment, supplies, and advertising for their "Grand Opening" on October 1. The partnership will use the accrual method of accounting. The following are some of the costs incurred during Heron's first year of operations.

Legal fees to form partnership	$ 2,000
Advertising for "Grand Opening"	15,000
Advertising after opening	10,000
Consulting fees for establishing accounting system	5,000
Rent, at $2,000 per month	12,000
Utilities, at $600 per month	3,600
Salaries to sales clerks	30,000
Payments to Carl and Megan for services ($5,000 per month each for three months)	30,000
Tax return preparation expense	5,000

In addition, Heron purchased all of the assets of Granny Newcombs, Inc. Of the total purchase price for these assets, $60,000 was allocated to the Granny Newcombs trade name and logo.

Determine how each of the above costs is treated by the partnership, and identify the period over which the costs can be deducted, if any.

21. **LO.7** Four GRRLs Partnership is owned by four sisters. Lisa holds a 70% interest; each of the others owns 10%. Lisa sells investment property to the partnership for its fair market value of $100,000. Her tax basis was $150,000.
a. How much loss, if any, may Lisa recognize?
b. If Four GRRLs later sells the property for $160,000, how much gain must it recognize?
c. If Lisa's basis in the investment property was $20,000 instead of $150,000, how much, if any, gain would she recognize on the sale of the property to Four GRRLs? How is it characterized?

22. **LO.3** Comment on the validity of each of the following statements.
a. Since a partnership is not a taxable entity, it is not required to file any type of Federal income tax return.
b. Generally, a transfer of appreciated property to a partnership results in recognized gain to the contributing partner at the time of the transfer.

c. When a partner renders services to the entity in exchange for an unrestricted interest, that partner does not recognize any gross income.
d. Property that was held as inventory by a contributing partner, but is a capital asset in the hands of the partnership, triggers a capital gain if the partnership immediately sells the property.
e. Each partner can choose a different method of accounting and depreciation computation in determining the gross income from the entity.
f. A partnership may choose a year that results in the least aggregate deferral of tax to the partners, unless the IRS requires the use of a natural business year.
g. Built-in loss related to nondepreciable property contributed to a partnership is allocated to the contributing partner to the extent the loss eventually is recognized by the partnership.
h. A partner's basis in a partnership interest includes that partner's share of partnership liabilities.
i. A partner can carry forward, for an unlimited period of time, the partner's share of any partnership operating losses that exceed the partner's basis in the entity, provided the partner retains an ownership interest in the partnership.
j. Losses on sales between a partner and the partnership always are nondeductible.

23. **LO.7** FredCo and Fran are equal partners in the calendar year F & F Partnership. FredCo uses a fiscal year ending June 30, and Fran uses a calendar year. FredCo receives an annual guaranteed payment of $50,000. F & F's taxable income (after deducting FredCo's guaranteed payment) is $40,000 for 2010 and $50,000 for 2011.
    a. How much income from the partnership must FredCo report for its tax year ending June 30, 2011?
    b. How much income from the partnership must Fran report for her tax year ending December 31, 2011?
    c. Assume FredCo's annual guaranteed payment is increased to $60,000 starting on January 1, 2011, and the partnership's taxable income for 2010 and 2011 (after deducting FredCo's guaranteed payment) is the same (i.e., $40,000 and $50,000, respectively). What is the amount of income from the partnership that FredCo must report for its tax year ending June 30, 2011?

24. **LO.4, 7** Sonya, a calendar year individual, owns 20% of Philadelphia Cheese Treats, Inc., a C corporation that was formed on February 1, 2010. She receives a $5,000 monthly salary from the corporation, and Philadelphia Cheese Treats generates $200,000 of taxable income (after accounting for Sonya's payments) for its tax year ending January 31, 2011.
    a. How do these activities affect Sonya's 2010 adjusted gross income?
    b. Assume, instead, that Philadelphia Cheese Treats is a partnership (January 31 year-end) and that it classifies Sonya's salary as a guaranteed payment. How do these activities affect Sonya's 2010 and 2011 adjusted gross income?

ISSUE ID
DECISION MAKING

25. **LO.6** Tom Garrison is a 30% member of GF&E, LLC. He purchased the interest as an investment. Although he is not currently involved in the LLC's day-to-day operations, he plans to become more active during the current year. Assuming that GF&E is expected to report a loss in the current tax year, describe the loss limitations that apply to Tom's share. What actions can he take to ensure that any loss is fully deductible? Assume that the partnership is *not* engaged in real estate activities.

CRITICAL THINKING

26. **LO.5, 6** Peggy and Cindy, parent and child, operate a local apparel shop as a partnership. The PC Partnership earned a profit of $80,000 in the current year. Cindy's equal partnership interest was acquired by gift from Peggy. Assume that capital is a material income-producing factor and that Peggy manages the day-to-day operations of the shop without any help from Cindy. Reasonable compensation for Peggy's services is $30,000.
    a. How much of the partnership income is allocated to Peggy?
    b. What is the maximum amount of partnership income that can be allocated to Cindy?
    c. Assuming that Cindy is five years old, has no other income, and is claimed as a dependent by Peggy, how is Cindy's income from the partnership taxed?

CRITICAL THINKING

27. **LO.5** Melinda, Gabe, and Pat each contributed $10,000 cash to start up the MGP General Partnership on January 1 this year. Each partner shares equally in partnership income, losses, deductions, gains, and credits. At the end of the year, the partnership balance sheet reads as follows.

	Basis	FMV		Basis	FMV
Assets	$60,000	$75,000	Recourse debt	$30,000	$30,000
			Melinda, capital	14,000	19,000
			Gabe, capital	14,000	19,000
			Pat, capital	2,000	7,000
				$60,000	$75,000

How will the basis computations of the partners' interests be affected by the partnership debt?

28. **LO.4, 5, 7** At the beginning of the tax year, Monica's basis in the MIP LLC was $100,000, including Monica's $50,000 share of the LLC's liabilities. At the end of the year, MIP distributed to Monica cash of $20,000 and inventory (basis of $10,000, fair market value of $16,000). In addition, MIP repaid all of its liabilities by the end of the year. **CRITICAL THINKING**
    a. If this is a proportionate nonliquidating distribution, what is the tax effect of the distribution to Monica and MIP? After the distribution, what is Monica's basis in the inventory and in her MIP interest?
    b. Would your answers to (a) change if this had been a proportionate liquidating distribution?

29. **LO.2, 4, 5** Celeste contributed business-related assets valued at $250,000 (basis of $100,000) in exchange for her 50% interest in the Celestine Partnership. Ernestine contributed land and a building valued at $400,000 (basis of $200,000) in exchange for the remaining 50% interest. Ernestine's property was encumbered by a qualified nonrecourse debt of $150,000, which was assumed by the partnership. The partnership reports the following income and expenses for the current tax year. **CRITICAL THINKING**

Sales	$350,000
Utilities, salaries, and other operating expenses	190,000
Qualified dividend income	6,000
Tax-exempt interest income	2,000
Charitable contributions	1,000
Distribution to Celeste	20,000
Distribution to Ernestine	10,000

At the end of the current tax year, Celestine held recourse debt of $100,000 for partnership accounts payable and qualified nonrecourse debt of $140,000.
    a. What is Celeste's basis after formation of the partnership? Ernestine's basis?
    b. What income and separately stated items does the partnership report on Celeste's Schedule K–1? What items does she report on her tax return?
    c. Assume all partnership debts are shared equally. At the end of the tax year, what are Celeste's basis and amount at risk in her partnership interest?

30. **LO.2, 4, 5, 8** Continue with the facts presented in Problem 29, except that Celestine was formed as an LLC instead of a general partnership. **ISSUE ID**
    a. What would be Celeste's share of the LLC's ending liabilities?
    b. How would Celeste's basis and amount at risk be different?

COMPREHENSIVE TAX RETURN PROBLEM

31. Myron M. Fox, Rhoda R. Fiori, Cassandra P. Martin, and Henrietta Q. Pasquale are equal partners in FFMP, LLP, a small business consulting services firm. The partners are not related, and all are U.S. citizens. The limited liability partnership uses the cash basis and the calendar year and began operations on January 1, 2006. Since that time, it has experienced significant growth each year. Its current address is 2835 Harbor View Drive, Freetown, ME 04469. The following information was taken from the LLP's income statement for the current year. **TAX RETURN PROBLEM**



Revenues	
Fees collected	$800,000
Dividend income (all qualified)	3,600
Taxable business interest	1,400
Tax-exempt interest	2,600
Long-term capital loss	(4,000)
Total revenues	$803,600
Expenses	
Accounting fees	$ 12,000
Advertising	5,000
Contribution to United Fund charity	2,000
Depreciation expense	8,119
Employee salaries	340,000
Guaranteed payment, Myron M. Fox, office manager	140,000
Entertainment, before 50% disallowance	2,600
Travel	12,000
Equipment rental	6,000
Office rentals paid	7,000
Interest expense	4,000
Insurance premiums	2,200
Office expense	20,481
Payroll taxes	25,600
Utilities	15,700
Total expenses	$602,700

The partnership placed its $65,000 of furniture and fixtures in service on January 1, 2006. This year, it claimed $8,119 of depreciation expense for both tax and financial accounting purposes. The depreciation creates an adjustment of $156 for alternative minimum tax purposes. No assets were placed in service during the year.

On October 15, the partnership sold securities for $40,000; it had purchased the securities for $44,000 on February 3, 2008. The firm's activities do not constitute "qualified production activities" for purposes of the § 199 deduction.

Net income per books is $200,900. On January 1, 2009, the partners' capital accounts equaled $60,000 each. No additional capital contributions were made in 2009, and each partner made cash withdrawals of $60,000 during the year. The partnership's balance sheet as of December 31, 2009, is as follows.

	Beginning	Ending
Cash	$ 86,576	$?
Tax-exempt securities	52,000	52,000
Marketable securities	120,000	76,000
Office furniture and equipment	65,000	65,000
Accumulated depreciation	(36,576)	?
Total assets	$287,000	$?
Nonrecourse debt payable on equipment	$ 47,000	$ 32,000
Capital, Fox	60,000	?
Capital, Fiori	60,000	?
Capital, Martin	60,000	?
Capital, Pasquale	60,000	?
Total liabilities and capital	$287,000	$?

All debt is shared equally by the partners. No noncash distributions were made by the entity to its owners this year.

None of the partners sold any portion of an interest in FFMP during the year. All of the entity's financial operations are concentrated in Maine, although consulting contracts were secured in other states during the year.

The partnership had no foreign bank accounts or operations, and it held no interest in any foreign trusts or any other partnerships. The partnership is not publicly traded and is not a statutory tax shelter. The partnership is not subject to consolidated audit procedures, and it currently does not have a designated tax matters partner.

The business code for FFMP's operations is 561900. Assume that the Federal ID number for the business is 11–1111111. FFMP itself is not a partner in any other partnership. The partnership's Form 1065 is prepared by Fox and is sent to the IRS Service Center in Cincinnati, Ohio. All partners are active in partnership operations.

a. Prepare Form 1065 and Schedule K for FFMP Partnership, leaving blank any items where insufficient information has been provided.
b. Prepare Schedule K–1 for Myron M. Fox, 415 Knight Court, Freetown, ME 04469. His Social Security number is 111–11–1111.



1. What is the function of a partner's capital account under the rules of generally accepted accounting principles (GAAP)? What is the partner's initial balance in the capital account? How and when does the capital account increase and decrease? What is the GAAP treatment of distributions to a partner?

2. Jim Dunn, Amy Lauersen, and Tony Packard have agreed to form a partnership. In return for a 30% capital interest, Dunn transferred machinery (basis $268,000, fair market value $400,000) subject to a liability of $100,000. The liability was assumed by the partnership. Lauersen transferred land (basis $450,000, fair market value $300,000) for a 30% capital interest. Packard transferred cash of $400,000 for the remaining 40% interest. Compute the initial values of Dunn's:
   a. Basis in his partnership interest for tax purposes.
   b. Capital account for financial reporting purposes.

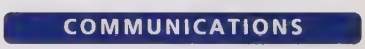
RESEARCH PROBLEMS

Note: Solutions to Research Problems can be prepared by using the **Checkpoint® Student Edition** online research product, which is available to accompany this text. It is also possible to prepare solutions to the Research Problems by using tax research materials found in a standard tax library.



Research Problem 1. Your clients, Mark Henderson and John Burton, each contributed $10,000 cash to form the Realty Management Partnership, a limited partnership. Mark is the general partner, and John is the limited partner. The partnership used the $20,000 cash to make a down payment on a building. The rest of the building's $200,000 purchase price was financed with an interest-only nonrecourse loan of $180,000, which was obtained from an independent third-party bank. The partnership allocates all partnership items equally between the partners except for the MACRS deductions and building maintenance, which are allocated 70% to John and 30% to Mark. The partnership definitely wishes to satisfy the "economic effect" requirements of Reg. §§ 1.704–1 and 1.704–2 and will reallocate MACRS, if necessary, to satisfy the requirements of the Regulations.





Under the partnership agreement, liquidation distributions will be paid in proportion to the partners' positive capital account balances. Capital accounts are maintained as required in the Regulations. Mark has an unlimited obligation to restore his capital account while John is subject to a qualified income offset provision.

All partnership items, except for MACRS, net to zero throughout the first three years of the partnership operations. Each year's MACRS deduction is $10,000 (to simplify the calculations).

Draft a letter to the partnership evaluating the allocation of MACRS in each of the three years. The partnership's address is 53 East Marsh Ave., Smyrna, GA 30082. Do not address the "substantial" test.

CRITICAL THINKING

COMMUNICATIONS

Research Problem 2. Fred and Grady have formed the FG Partnership to operate a retail establishment selling antique household furnishings. Fred is the general partner, and Grady is the limited partner. Both partners contribute $15,000 to form the partnership. The partnership uses the $30,000 contributed by the partners and a recourse loan of $100,000 obtained from an unrelated third-party lender to acquire $130,000 of initial inventory.

The partners believe they will incur extensive losses in the first year due to advertising and initial cash-flow requirements. Fred and Grady have agreed to share losses equally. To make sure the losses can be allocated to both partners, they have included a provision in the partnership agreement requiring each partner to restore any deficit balance in his partnership capital account upon liquidation of the partnership.

Fred also was willing to include in the partnership agreement a provision that requires him to make up any deficit balance within 90 days of liquidation of the partnership. As a limited partner, Grady argued that he should not be subject to such a time requirement. The partners compromised and included a provision that requires Grady to restore a deficit balance in his capital account within the two years following any liquidation of the partnership. No interest will be owed on Grady's deferred restoration payment.

How is the debt allocated to the partners' respective bases? Describe the general rules that apply, and cite your references.

Summarize your findings in an e-mail to your instructor. Hint: You will find that FG cannot allocate the $100,000 recourse debt equally to the two partners. Where appropriate, assume that a 10% interest rate, compounded semiannually, applies.

Research Problem 3. Cameron, an individual, and Totco, Inc., a domestic C corporation, have decided to form CT, a California LLC. The new LLC will produce a product that Cameron recently developed and patented. Cameron and Totco, Inc., each will take a 50% capital and profits interest in the LLC. Cameron is a calendar year taxpayer, while Totco is taxed on a July 1–June 30 fiscal year. The LLC does not have a "natural business year" and elects to be taxed as a partnership.

a. Determine the taxable year of the LLC under the existing Code and Regulations.
b. Two years after formation of the LLC, Cameron sells half of his interest (25%) to Totco, Inc. Can the LLC retain the taxable year determined in part (a)?



Use the tax resources of the Internet to address the following questions. Do not restrict your search to the Web, but include a review of newsgroups and general reference materials, practitioner sites and resources, primary sources of the tax law, chat rooms and discussion groups, and other opportunities.

Research Problem 4. Print an article posted by a law firm that comments on pitfalls to avoid in drafting partnership agreements. Ideally, use the home page of a firm that has offices in your state.

Research Problem 5. Find the statutes and regulations that control limited liability companies (LLCs) in your state. What types of business activities can and cannot an LLC conduct in your state?

COMMUNICATIONS

Research Problem 6. Find a blog that concentrates on the taxation of partners and partnerships. Post a message defining the terms "inside and outside basis" and illustrating why the distinction between them is important. Respond to any replies you receive. Print your message and one or two of the replies.

COMMUNICATIONS

Research Problem 7. Determine the statutory tax treatment in your state of a one-member LLC. Write an e-mail message to your professor, comparing this rule with Federal tax law.

COMMUNICATIONS

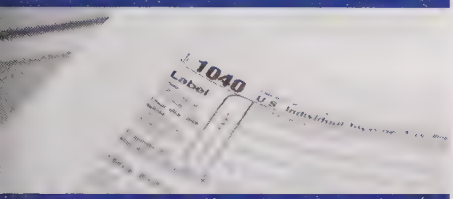
Research Problem 8. Graph the increases in the numbers of LLCs and LLPs filing Federal tax returns, for five-year periods beginning with 1970. Explain any trends in the data that you identify. Send your report as an e-mail to your instructor.

COMMUNICATIONS

Research Problem 9. One of the IRS's targeted items in its "priority guidance plan" is to issue guidelines related to a partner's receipt of a profits interest or an interest in the future capital of the partnership (also called a "carried interest"). Determine whether the Treasury or IRS has acted on this. Summarize your findings in no more than four PowerPoint slides, to present to your classmates.

CHAPTER 12

S Corporations



LEARNING OBJECTIVES

After completing Chapter 12, you should be able to:

LO.1 Explain the **tax effects associated with S corporation status**. **(pp. 12-2 to 12-4)**

LO.2 Identify **corporations that qualify for the S election**. **(pp. 12-4 to 12-7)**

LO.3 Explain **how to make and terminate an S election**. **(pp. 12-7 to 12-10)**

LO.4 Compute **nonseparately stated income and allocate income, deductions, and credits** to shareholders. **(pp. 12-11 to 12-14)**

LO.5 Determine how **distributions to S corporation shareholders** are taxed. **(pp. 12-15 to 12-20)**

LO.6 Calculate a **shareholder's basis** in S corporation stock. **(pp. 12-20 to 12-22)**

LO.7 Explain the tax effects of **losses** on S shareholders. **(pp. 12-22 to 12-25)**

LO.8 Compute the **entity-level taxes** on S corporations. **(pp. 12-25 to 12-29)**

TAX *Talk*

In levying taxes and in shearing sheep it is well to stop when you get down to the skin.

—Austin O'Malley

OUTLINE

12.1 An Overview of S Corporations, 12-3
12.2 Qualifying for S Corporation Status, 12-4
Definition of a Small Business Corporation, 12-4
Making the Election, 12-7
Shareholder Consent, 12-8
Loss of the Election, 12-8
12.3 Operational Rules, 12-11
Computation of Taxable Income, 12-11
Allocation of Income and Loss, 12-12
Tax Treatment of Distributions to Shareholders, 12-15
Tax Treatment of Noncash Distributions by the Corporation, 12-19
Shareholder's Basis, 12-20
Treatment of Losses, 12-22
Other Operational Rules, 12-24
12.4 Entity-Level Taxes, 12-25
Tax on Pre-Election Built-in Gain, 12-25
Passive Investment Income Penalty Tax, 12-28
12.5 Summary, 12-29

THE BIG PICTURE Tax Solutions for the Real World

CONVERTING A C CORPORATION TO AN S CORPORATION

Fowle, Inc., has been operating as a C corporation for a number of years, earning taxable income of less than $100,000 per year. The company has accumulated its earnings for a variety of business needs and has not paid dividends to date. Thus, the corporation has been able to take advantage of lower C corporation tax rates and has avoided double taxation problems so far.

Fowle receives some tax-exempt income, generates a small domestic production activities deduction (DPAD), and holds about $200,000 of C corporation earnings and profits. The company's owner, David, currently draws a salary of $92,000. Fowle has two classes of stock, voting and nonvoting common.

The company now is facing increased competition as a result of cheaper imports from China. David expects very large operating losses for the next few years. David would like to know if he can deduct the anticipated losses. **Read the chapter and formulate your response.**

LO.1

Explain the tax effects associated with S corporation status.

An individual establishing a business has a number of choices as to the form of business entity under which to operate. Chapters 9 and 10 outline many of the rules, advantages, and disadvantages of operating as a regular C corporation. Chapter 11 discusses the partnership entity, as well as the limited liability company (LLC) and limited liability partnership (LLP) forms.

Another alternative, the **S corporation**, provides many of the benefits of partnership taxation and at the same time gives the owners limited liability protection from creditors. The S corporation rules, which are contained in **Subchapter S** of the Internal Revenue Code (§§ 1361–1379), were enacted to allow flexibility in the entity choice that businesspeople face. Thus, S status combines the legal environment of C corporations with taxation similar to that applying to partnerships. S corporation status is obtained through an election by a *qualifying* corporation with the consent of its shareholders.

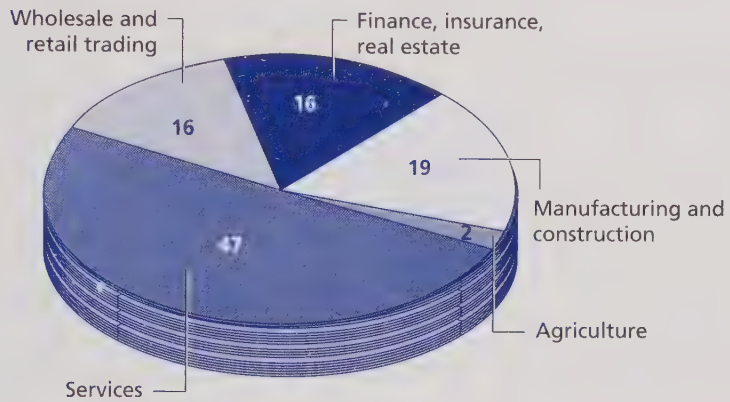
S corporations are treated as corporations under state law. They are recognized as separate legal entities and generally provide shareholders with the same liability protection afforded by C corporations. Some states (such as Michigan) treat S corporations as C corporations for tax purposes, resulting in a state corporate income or franchise tax liability. For Federal income tax purposes, however, the taxation of S corporations resembles that of partnerships. As with partnerships, the income, deductions, and tax credits of an S corporation flow through to shareholders annually, regardless of whether distributions are made. Thus, income generally is taxed at the shareholder level and not at the corporate level. Distributions made to S shareholders by the corporation are tax-free to the extent that the distributed earnings were previously taxed.

TAX FACT

The Business of S Corporations

S corporations file about 4 million tax returns every year, concentrated in the service and manufacturing industries.

S Corporation Returns Filed (%), 2006 Tax Year



Although the tax treatment of S corporations and partnerships is similar, it is not identical. For example, liabilities affect an owner's basis differently, and S corporations may incur a tax liability at the corporate level. In addition, a variety of C corporation provisions apply to S corporations. For example, the liquidation of C and S corporations is taxed in the same way. As a rule, where the S corporation provisions are silent, C corporation rules apply.

12.1 An Overview of S Corporations

Since the inception of S corporations in 1958, their popularity has waxed and waned with changes in the tax law. Before the Tax Reform Act of 1986, their ranks grew slowly. In contrast, in the two years following the 1986 law change, the number of S corporations increased by 52 percent. Now, about 4 million of the country's 6.6 million corporations have elected S status. The IRS projects that S corporations and limited liability companies (LLCs) will be the most-chosen forms of business entity for the next decade.

EXAMPLE 1

An S corporation earns $300,000, and all after-tax income is distributed currently. The marginal individual tax rate applicable to its shareholders is 35% for ordinary income and 15% for dividend income. The marginal corporate tax rate is 34%. The entity's available after-tax earnings, compared with those of a similar C corporation, are computed below.

	C Corporation	S Corporation
Earnings	$ 300,000	$ 300,000
Less: Corporate income tax	(102,000)	(–0–)
Amount available for distribution	$ 198,000	$ 300,000
Less: Income tax at owner level	(29,700)*	(105,000)**
Available after-tax earnings	$ 168,300	$ 195,000

*$198,000 × 15% dividend income tax rate.
**$300,000 × 35% ordinary income tax rate.



Bridge to Business Law

An S corporation is a corporation for all purposes other than its Federal and state income tax law treatment. The entity registers as a corporation with the secretary of state of the state of its incorporation. It issues shares and may hold some treasury stock. Dealings in its own stock are not taxable to the S corporation.

The corporation itself is attractive as a form of business ownership because it offers limited liability to all shareholders from the claims of customers, employees, and others. This is not the case for any type of partnership, where there always is at least one general partner bearing the ultimate personal liability for the operations of the entity (except in the new limited liability limited partnership). Forming an entity as an S corporation facilitates the raising of capital for the business, as an infinite number of shares can be divided in any way imaginable, so as to pass income and deductions, gains, losses, and credits through to the owners, assuming that the fairly generous "type of shareholder" requirements continue to be met.

An S corporation must comply with all licensing and registration requirements of its home state under the rules applicable to corporate entities. Some states levy privilege taxes on the right to do business in the corporate form, and the S corporation typically is not exempted from this tax.

Because an S corporation is a separate legal entity from its owners, shareholders can be treated as employees and receive qualified retirement and fringe benefits under the Code, as well as unemployment and worker's compensation protection through the corporation. Some limitations apply to the deductibility of fringe benefits, though.

The tax fiction of the S corporation is attractive to investors, as over one-half of all U.S. corporations have an S election in effect.

The S corporation generates an extra $26,700 of after-tax earnings ($195,000 − $168,300), when compared with a similar C corporation. The C corporation might be able to reduce this disadvantage, however, by paying out its earnings as compensation, rents, or interest to its owners. In addition, tax at the owner level is deferred or avoided by not distributing after-tax earnings. ■

EXAMPLE 1

A new corporation elects S status and incurs a net operating loss (NOL) of $300,000. The shareholders may use their proportionate shares of the NOL to offset other taxable income in the current year, providing an immediate tax savings. In contrast, a newly formed C corporation is required to carry the NOL forward for up to 20 years and receives no tax benefit in the current year. Hence, an S corporation can accelerate the use of NOL deductions and thereby provide a greater present value for the tax savings generated by the loss. ■

Limited liability companies can provide tax results similar to those of an S corporation, while avoiding some of the key restrictions that are imposed on S corporations and their shareholders. However, recent changes to a number of S corporation election and operating rules provide greater flexibility in using S corporations as a viable alternative to LLCs.

12.2 Qualifying for S Corporation Status

LO.2
Identify corporations that qualify for the S election.

DEFINITION OF A SMALL BUSINESS CORPORATION

To achieve S corporation status, a corporation *first* must qualify as a **small business corporation**. A small business corporation:

- Is a domestic corporation (incorporated and organized in the United States).
- Is eligible to elect S corporation status.
- Issues only one class of stock.
- Is limited to a maximum of 100 shareholders.
- Has only individuals, estates, and certain trusts and exempt organizations as shareholders.
- Has no nonresident alien shareholders.

Tax Planning Strategies WHEN TO ELECT S CORPORATION STATUS

FRAMEWORK FOCUS: DEDUCTIONS

Strategy: Maximize Deductible Amounts.

FRAMEWORK FOCUS: TAX RATE

Strategy: Shift Net Income from High-Bracket Taxpayers to Low-Bracket Taxpayers.
Shift Net Income from High-Tax Jurisdictions to Low-Tax Jurisdictions.

The planner begins by determining whether an S election is appropriate for the entity. The following factors should be considered.

- If shareholders are subject to high marginal rates relative to C corporation rates, it may be desirable to avoid S corporation status. Although a C corporation may be subject to double taxation, this result can be mitigated by paying compensation to employee-shareholders. Likewise, profits of the corporation may be taken out by the shareholders through other compensation arrangements, as interest, or as rent income. Corporate profits can be transferred to shareholders as capital gain income through capital structure changes, such as stock redemptions, liquidations, or sales of stock to others. Alternatively, profits may be paid out as dividends at a maximum 15 percent tax rate. Any distribution of profits or sale of stock can be deferred to a later year, thereby reducing the present value of shareholder taxes. Finally, potential shareholder-level tax on corporate profits can be eliminated by a step-up in the basis of the stock upon the shareholder's death.
- S corporation status allows shareholders to realize tax benefits from corporate losses immediately—an important consideration in new business enterprises where operating losses are common. Thus, if corporate NOLs are anticipated and there is unlikely to be corporate income over the near term to offset with the NOLs, S corporation status is advisable. However, the deductibility of the losses to shareholders must also be considered. The at-risk and passive loss limitations (refer to Chapter 6) apply to losses generated by an S corporation. In addition, as discussed later in this chapter, shareholders may not deduct losses in excess of the tax basis in their S corporation stock. Together with the time value of money considerations of deferring any loss deduction, these limits may significantly reduce the benefits of an S corporation election in a loss setting.
- If the entity electing S status is currently a C corporation, NOL carryovers from prior years (refer to Chapter 6) generally cannot be used in an S corporation year. Even worse, S corporation years use up the 20-year carryover period.
- Distributions of earnings from C corporations are usually taxed using the preferential 15 percent (or 0 percent) tax rate. In contrast, because S corporations are flow-through entities, all deduction and income items retain any special tax characteristics when they are reported on shareholders' returns. Whether this consideration favors S status depends upon the character of income and deductions of the S corporation.
- Because S corporations are flow-through entities, separately stated items retain their tax characteristics on the shareholders' returns. For instance, it may be an advantage to receive the flow-through of passive income, or the domestic production activities deduction, on the shareholder's tax return, making the S election more attractive.
- State and local tax laws also should be considered when making the S corporation election. Although an S corporation usually escapes Federal income tax, it may not be immune from all state and local income taxes.

Unlike other small business provisions in the tax law (e.g., § 1244), no maximum or minimum dollar sales or capitalization restrictions apply to S corporations.

Ineligible Corporations

S status is not permitted for foreign corporations, certain banks, or insurance companies. S corporations are permitted to have wholly owned C and S corporation subsidiaries.[1]

[1]Other eligibility rules exist. § 1361(b).

TAX in the NEWS

S Corporation Audits

The IRS is studying S corporations' reporting compliance. Benson Goldstein, technical manager for the AICPA Tax Division, says that "recent research points to S corporations as a significant source of noncompliance, particularly among high-income individuals." But Tom Ochsenschlager, vice president of taxation for the AICPA, points out that "a lot of the errors made are errors, not malfeasance."

Form 1120S audits have increased by about 25 percent in recent years.

One Class of Stock

A small business corporation may have only one class of stock issued and outstanding.[2] This restriction permits differences in voting rights, but not differences in distribution or liquidation rights.[3] Thus, two classes of common stock that are identical except that one class is voting and the other is nonvoting are treated as a single class of stock for S corporation purposes. In contrast, voting common stock and voting preferred stock (with a preference on dividends) are treated as two classes of stock. Authorized and unissued stock or treasury stock of another class does not disqualify the corporation. Likewise, unexercised stock options, phantom stock, stock appreciation rights, warrants, and convertible debentures usually do not constitute a second class of stock.[4]

DIGGING DEEPER 1

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

Although the one-class-of-stock requirement seems straightforward, it is possible for debt to be reclassified as stock, resulting in an unexpected loss of S corporation status.[5] To mitigate concern over possible reclassification of debt as a second class of stock, the law provides a set of *safe harbor* provisions. Neither straight debt[6] nor short-term advances[7] constitute a second class of stock.

DIGGING DEEPER 2

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

Number of Shareholders

A small business corporation is limited to 100 shareholders. If shares of stock are owned jointly by two individuals, they generally are treated as separate shareholders. However, family members (ancestors, descendants, spouses, and former spouses) of the investor can be counted as one shareholder for purposes of determining the number of shareholders.[8]

EXAMPLE 3

Fred and Wilma (husband and wife) jointly own 10 shares in Oriole, Inc., an S corporation, with the remaining 90 shares outstanding owned by 99 other shareholders. Fred and Wilma are divorced. Both before and after the divorce, the 100-shareholder limit is met, and Oriole can qualify as a small business corporation. ■

Type of Shareholder Limitation

Small business corporation shareholders may be individuals, estates, or certain trusts and exempt organizations.[9] This limitation prevents partnerships, corporations,

[2] § 1361(b)(1)(D).
[3] § 1361(c)(4).
[4] Reg. § 1.1361–1(l)(2).
[5] Refer to the discussion of debt-versus-equity classification in Chapter 9.
[6] § 1361(c)(5)(A).
[7] Reg. § 1.1361–1(l)(4).
[8] §§ 1361(c)(1)(A)(ii) and (B)(i). Notice 2005–91, 2005–51 I.R.B. 1164.
[9] § 1361(b)(1)(B).

most LLCs, LLPs, and most IRAs from owning S corporation stock. Without this rule, partnerships and corporate shareholders could easily circumvent the 100-shareholder limitation.

EXAMPLE 4

Paul and 200 other individuals wish to form an S corporation. Paul reasons that if the group forms a partnership, the partnership can then form an S corporation and act as a single shareholder, thereby avoiding the 100-shareholder rule. Paul's plan will not work, because partnerships cannot own stock in an S corporation. ■

Tax Planning Strategies BEATING THE 100-SHAREHOLDER LIMIT

FRAMEWORK FOCUS: TAX RATE

Strategy: Avoid Double Taxation.

Although partnerships and corporations cannot own small business corporation stock, S corporations themselves can be partners in a partnership or shareholders in a corporation. In this way, the 100-shareholder requirement can be bypassed in a limited sense. For example, if two S corporations, each with 80 shareholders, form a partnership, then the shareholders of both corporations can enjoy the limited liability conferred by S corporation status and a single level of tax on the resulting profits.

Nonresident Aliens

Nonresident aliens cannot own stock in a small business corporation.[10] Thus, individuals who are not U.S. citizens *must live in the United States* to own S corporation stock. Shareholders with nonresident alien spouses in community property states[11] cannot own S corporation stock because the nonresident alien spouse is treated as owning half of the stock.[12] Similarly, if a resident alien shareholder moves outside the United States, the S election is terminated.

MAKING THE ELECTION

LO.3

Explain how to make and terminate an S election.

To become an S corporation, the entity must file a valid election with the IRS. The election is made on Form 2553. For the election to be valid, it should be filed on a timely basis, and all shareholders must consent. For S corporation status to apply in the current tax year, the election must be filed either in the previous year or on or before the fifteenth day of the third month of the current year.[13]

EXAMPLE 5

In 2010, a calendar year C corporation decides to become an S corporation beginning January 1, 2011. The S corporation election can be made at any time in 2010 or by March 15, 2011. An election after March 15, 2011, is not effective until the 2012 tax year. ■

Even if the 2½-month deadline is met, an S election is not valid unless the corporation qualifies as a small business corporation for the *entire* tax year. Otherwise, the election is effective for the following tax year. Late elections, filed after the 2½-month deadline, may be considered timely if there is reasonable cause for the late filing.

A corporation that does not yet exist cannot make an S corporation election.[14] Thus, for new corporations, a premature election may not be effective. A new corporation's 2½-month election period begins at the earliest occurrence of any of the following events.

[10] § 1362(b)(1)(C).

[11] Assets acquired by a married couple are generally considered community property in these states: Alaska (by election), Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin.

[12] See *Ward v. U.S.*, 81-2 USTC ¶9674, 48 AFTR 2d 81-5942, 661 F.2d 226 (Ct.Cls., 1981), where the court found that the stock was owned as community property. Since the taxpayer-shareholder (a U.S. citizen) was married to a citizen and resident of Mexico, the nonresident alien prohibition was violated. If the taxpayer-shareholder had held the stock as separate property, the S election would have been valid.

[13] § 1362(b). Extensions of time to file Form 2553 may be possible in certain situations; see Rev.Proc. 2007-62, 2007-41 I.R.B. 786.

[14] See, for example, *T.H. Campbell & Bros., Inc.*, 34 TCM 695, T.C.Memo. 1975-149; Ltr.Rul. 8807070.

- When the corporation has shareholders.
- When it acquires assets.
- When it begins doing business.[15]

SHAREHOLDER CONSENT

A qualifying election requires the consent of all of the corporation's shareholders.[16] Consent must be in writing, and it generally must be filed by the election deadline. Both husband and wife must consent if they own their stock jointly (as joint tenants, tenants in common, tenants by the entirety, or community property).[17] Although no authority exists for the entity to obtain an extension of time to file an S election (Form 2553), a shareholder may receive an extension of time to file a consent.

EXAMPLE 6

Vern and Yvonne decide to convert their C corporation into a calendar year S corporation, effective for this year. At the end of February (before the election is filed), Yvonne travels to the Ukraine and forgets to sign a consent to the election. Yvonne will not return to the United States until June and cannot be reached by fax or e-mail. Vern files the Form 2553 and also requests an extension of time to file Yvonne's consent to the election. Vern indicates that there is a reasonable cause for the extension: a shareholder is out of the country.

Since the government's interest is not jeopardized, the IRS probably will grant Yvonne an extension of time to file the consent. Vern must file the corporation's election on Form 2553 on or before March 15 for S status to be effective for the current calendar year. ■

Tax Planning Strategies MAKING A PROPER ELECTION

FRAMEWORK FOCUS: TAX RATE

Strategy: Avoid Double Taxation.

- Because S corporation status is *elected*, strict compliance with the requirements is demanded by both the IRS and the courts. Any failure to meet a condition in the law may lead to loss of the S election and raise the specter of double tax.
- Make sure all shareholders consent. If any doubt exists concerning the shareholder status of an individual, it would be wise to request that he or she sign a consent anyway.[18] Missing consents are fatal to the election; the same cannot be said for too many consents.
- Be sure that the election is timely and properly filed. Either deliver the election to an IRS office in person, or send it by certified or registered mail or via a major overnight delivery service. The date used to determine timeliness is the postmark date, not the date the IRS receives the election.

DIGGING DEEPER 3

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

LOSS OF THE ELECTION

An S election remains in force until it is revoked or lost. Election or consent forms are not required for future years. However, an S election can terminate if any of the following occurs.[19]

[15]Reg. § 1.1372–2(b)(1). Also see, for example, *Nick A. Artukovich*, 61 T.C. 100 (1973).

[16]§ 1362(a)(2).

[17]Rev.Rul. 60–183, 1960–1 C.B. 625; *William Pestcoe*, 40 T.C. 195 (1963); Reg. § 1.1362–6(b)(3)(iii). This rule likely applies to all family members being treated as one shareholder.

[18]See *William B. Wilson*, 34 TCM 463, T.C.Memo. 1975–92.

[19]§ 1362(d).

- Shareholders owning a majority of shares (voting and nonvoting) voluntarily revoke the election.
- A new shareholder owning more than one-half of the stock affirmatively refuses to consent to the election.
- The corporation no longer qualifies as a small business corporation.
- The corporation does not meet the passive investment income limitation.

Voluntary Revocation

A **voluntary revocation** of the S election requires the consent of shareholders owning a majority of shares on the day that the revocation is to be made.[20] A revocation filed up to and including the fifteenth day of the third month of the tax year is effective for the entire tax year, unless a later date is specified. Similarly, unless an effective date is specified, a revocation made after the first 2½ months of the current tax year is effective for the following tax year.

EXAMPLE 7

The shareholders of Petunia Corporation, a calendar year S corporation, voluntarily revoke the S election on January 5, 2010. They do not specify a future effective date in the revocation. Assuming the revocation is properly executed and timely filed, Petunia will be a C corporation for the entire 2010 tax year. If the revocation is not made until June 2010, Petunia remains an S corporation in 2010 and becomes a C corporation at the beginning of 2011. ■

A corporation can revoke its S status *prospectively* by specifying a future date when the revocation is to be effective. A revocation that designates a future effective date splits the corporation's tax year into a short S corporation year and a short C corporation year. The day on which the revocation occurs is treated as the first day of the C corporation year. The corporation allocates income or loss for the entire year on a pro rata basis, based on the number of days in each short year.

EXAMPLE 8

Assume the same facts as in the preceding example, except that Petunia designates July 1, 2010, as the revocation date. Accordingly, June 30, 2010, is the last day of the S corporation's tax year. The C corporation's tax year runs from July 1, 2010, to December 31, 2010. Income or loss for the 12-month period is allocated between the two short years (i.e., 184/365 to the C corporation year). ■

Rather than using pro rata allocation, the corporation can elect to compute the actual income or loss attributable to the two short years. This election requires the consent of everyone who was a shareholder at any time during the S corporation's short year and everyone who owns stock on the first day of the C corporation's year.[21]

Loss of Small Business Corporation Status

If an S corporation fails to qualify as a small business corporation at any time after the election has become effective, its status as an S corporation ends. The termination occurs on the day that the corporation ceases to be a small business corporation.[22] Thus, if the corporation ever has more than 100 shareholders, a second class of stock, or a nonqualifying shareholder, or otherwise fails to meet the definition of a small business corporation, the S election is terminated immediately.

EXAMPLE 9

Peony Corporation has been a calendar year S corporation for three years. On August 13, 2010, one of its 100 shareholders sells *some* of her stock to an outsider. Peony now has 101 shareholders, and it ceases to be a small business corporation. Peony is an S corporation through August 12, 2010, and a C corporation from August 13 to December 31, 2010. ■

[20] § 1362(d)(1)(B).
[21] § 1362(e)(3).
[22] § 1362(d)(2)(B).

Passive Investment Income Limitation

The Code provides a **passive investment income (PII)** limitation for some S corporations that previously were C corporations or for S corporations that have merged with C corporations. If an S corporation has C corporation earnings and profits (E & P) and passive income in excess of 25 percent of its gross receipts for three consecutive taxable years, the S election is terminated as of the beginning of the fourth year.[23]

EXAMPLE 10

For 2007, 2008, and 2009, Chrysanthemum Corporation, a calendar year S corporation, derived passive income in excess of 25% of its gross receipts. If Chrysanthemum holds accumulated E & P from years in which it was a C corporation, its S election is terminated as of January 1, 2010. ■

PII includes dividends, interest, rents, gains and losses from sales of capital assets, and royalties net of investment deductions. Rents are not considered PII if the corporation renders significant personal services to the occupant.

EXAMPLE 11

Violet Corporation owns and operates an apartment building. The corporation provides utilities for the building, maintains the lobby, and furnishes trash collection for tenants. These activities are not considered significant personal services, so any rent income earned by the corporation will be considered PII.

Alternatively, if Violet also furnishes maid services to its tenants (personal services beyond what normally would be expected from a landlord in an apartment building), the rent income would no longer be PII. ■

Reelection after Termination

After an S election has been terminated, the corporation must wait five years before reelecting S corporation status. The five-year waiting period is waived if:

- there is a more-than-50-percent change in ownership of the corporation after the first year for which the termination is applicable, or
- the event causing the termination was not reasonably within the control of the S corporation or its majority shareholders.

Tax Planning Strategies PRESERVING THE S ELECTION

FRAMEWORK FOCUS: TAX RATE

Strategy: Avoid Double Taxation.

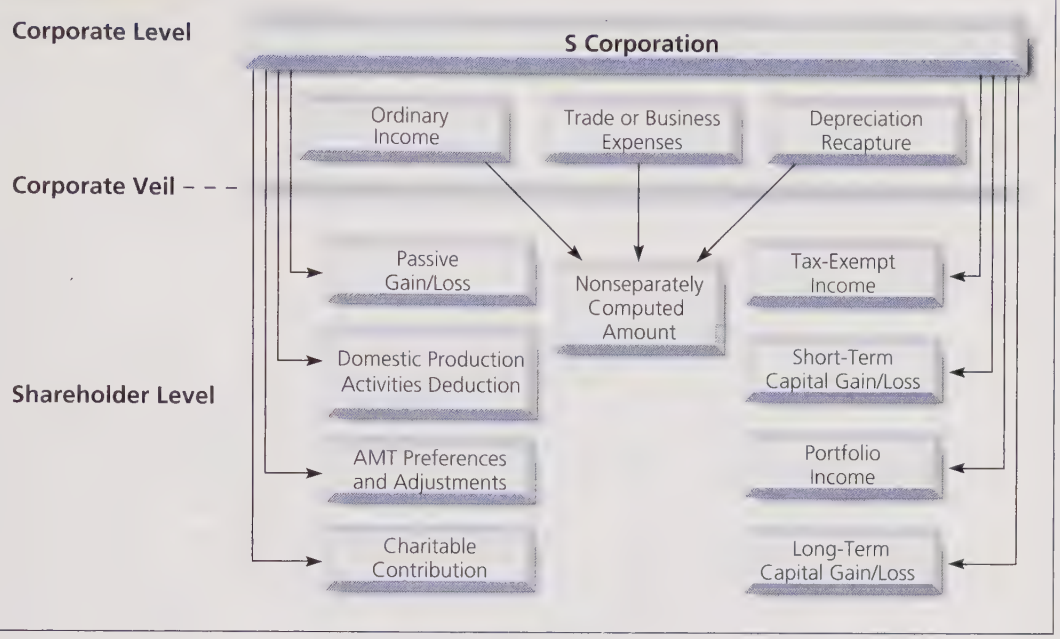
Unexpected loss of S corporation status can be costly to a corporation and its shareholders. Given the complexity of the rules facing these entities, constant vigilance is necessary to preserve the S election.

- As a starting point, the corporation's management and shareholders should be made aware of the various transactions that can lead to the loss of an election.
- Prevent violations of the small business corporation limitations. Since most such violations result from transfers of stock, the corporation and its shareholders should consider adopting a set of stock transfer restrictions. A carefully designed set of restrictions could prevent sale of stock to nonqualifying entities or violation of the 100-shareholder rule. Similarly, stock could be repurchased by the corporation under a buy-sell agreement upon the death of a shareholder, thereby preventing nonqualifying trusts from becoming shareholders.[24]

[23] § 1362(d)(3)(A)(ii).

[24] Most such agreements do not create a second class of stock. Rev.Rul. 85–161, 1985–2 C.B. 191; *Portage Plastics Co. v. U.S.*, 72–2 USTC ¶9567, 30 AFTR 2d 72–5229, 470 F.2d 308 (CA–7, 1973).

FIGURE 12.1 Flow-Through of Items of Income and Loss to S Corporation Shareholders



12.3 Operational Rules

LO.4

Compute nonseparately stated income and allocate income, deductions, and credits to shareholders.

S corporations are treated much like partnerships for tax purposes. With a few exceptions, S corporations generally make tax accounting and other elections at the corporate level.[25] Each year, the S corporation determines nonseparately stated income or loss and separately stated income, deductions, and credits. These items are taxed only once, as they pass through to shareholders. All items are allocated to each shareholder based on average ownership of stock throughout the year.[26] The flow-through of each item of income, deduction, and credit from the corporation to the shareholder is illustrated in Figure 12.1.

COMPUTATION OF TAXABLE INCOME

Subchapter S taxable income or loss is determined in a manner similar to the tax rules that apply to partnerships, except that S corporations recognize gains (but not losses) on distributions of appreciated property to shareholders.[27] Other special provisions affecting only the computation of C corporation income, such as the dividends received deduction, do not extend to S corporations.[28] Finally, as with partnerships, certain deductions of individuals are not permitted, including alimony payments, personal moving expenses, certain dependent care expenses, the personal exemption, and the standard deduction.

In general, S corporation items are divided into (1) nonseparately stated income or loss and (2) separately stated income, losses, deductions, and credits that could uniquely affect the tax liability of any shareholder. In essence, nonseparate items are aggregated into an undifferentiated amount that constitutes Subchapter S ordinary income or loss.

[25] Certain elections are made at the shareholder level (e.g., the choice between a foreign tax deduction or credit).

[26] §§ 1366(a), (b), and (c).

[27] § 1363(b).

[28] § 703(a)(2).

EXAMPLE 15

The following is the income statement for Larkspur, Inc., an S corporation.

Sales		$ 40,000
Less: Cost of goods sold		(23,000)
Gross profit on sales		$ 17,000
Less: Interest expense	$1,200	
Charitable contributions	400	
Advertising expenses	1,500	
Other operating expenses	2,000	(5,100)
Book income from operations		$ 11,900
Add: Tax-exempt interest	$ 300	
Dividend income	200	
Long-term capital gain	500	1,000
Less: Short-term capital loss		(150)
Net income per books		$ 12,750

Subchapter S ordinary income (i.e., nonseparately stated income) for Larkspur is calculated as follows, using net income for book purposes as the starting point.

Net income per books		$12,750
Separately stated items		
Deduct: Tax-exempt interest	$300	
Dividend income	200	
Long-term capital gain	500	(1,000)
Add: Charitable contributions	$400	
Short-term capital loss	150	550
Subchapter S ordinary income		$12,300

The $12,300 of Subchapter S nonseparately stated income, as well as each of the five separately stated items, are divided among the shareholders based upon their stock ownership. ■

An S corporation reports details as to the differences between book income and pass-through items on its Form 1120S, Schedule M–1 or M–3.

ALLOCATION OF INCOME AND LOSS

Each shareholder is allocated a pro rata portion of nonseparately stated income or loss and all separately stated items. The pro rata allocation method assigns an equal amount of each of the S items to each day of the year. If a shareholder's stock holding changes during the year, this allocation assigns the shareholder a pro rata share of each item for each day the stock is owned. On the date of transfer, the transferor (not the transferee) is considered to own the stock.[29]

S corporation item → (X) Percentage of shares owned → (X) Percentage of year shares were owned → (=) Amount of item to be reported

The per-day allocation must be used, unless the shareholder disposes of his or her entire interest in the entity.[30] In the case of a complete termination, a short year may result, as discussed below. If a shareholder dies during the year, his or her share of the pro rata items up to and including the date of death is reported on the final individual income tax return.

[29] Reg. § 1.1377–1(a)(2)(ii).

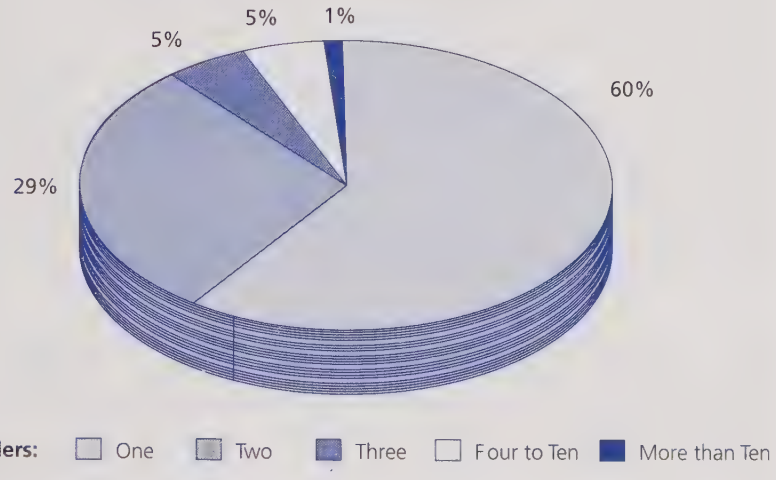
[30] §§ 1366(a)(1) and 1377(a)(1).

TAX

A "Small" Business Corporation

The majority of S corporations have only one shareholder.

Returns Filed by Number of S Corporation Shareholders, 2006 Tax Year



EXAMPLE 13

Pat, a shareholder, owned 10% of Larkspur's stock (from Example 12) for 100 days and 12% for the remaining 265 days. Using the required per-day allocation method, Pat's share of the Subchapter S ordinary income is the total of $12,300 × [10% × (100/365)] plus $12,300 × [12% × (265/365)], or $1,409. All of Pat's Schedule K–1 totals flow through to the corresponding lines on his individual income tax return (Form 1040). ■

The Short-Year Election

If a shareholder's interest is completely terminated during the tax year by disposition or death, all shareholders owning stock during the year and the corporation may elect to treat the S taxable year as two taxable years. The first year ends on the date of the termination. Under this election, an interim closing of the books is undertaken, and the shareholders report their shares of the S corporation items as they occurred during the short tax year.[31]

The short-year election provides an opportunity to shift income, losses, and credits among shareholders. The election is desirable in circumstances where more loss can be allocated to taxpayers with higher marginal tax rates.

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

4 DIGGING DEEPER

EXAMPLE 14

Alicia, the owner of all of the shares of an S corporation, transfers her stock to Cindy halfway through the tax year. There is a $100,000 NOL for the entire tax year, but $30,000 of the loss occurs during the first half of the year. Without a short-year election, $50,000 of the loss is allocated to Alicia and $50,000 is allocated to Cindy. If the

[31] § 1377(a)(2).

TAX in the NEWS

An Abusive Tax Shelter?

During the 2004 presidential campaign, some tax practitioners pointed out that Democratic vice presidential candidate John Edwards had approximately $20 million of legal fees inside his S corporation in 1995. By paying himself a salary of only $360,000, he avoided paying almost $600,000 for the Medicare portion of FICA taxes (imposed at a rate of 2.9 percent).

There was considerable discussion of Edwards's tax situation in the media, and Vice President Dick Cheney mentioned the issue in the vice presidential debate. Reactions tended to follow the party affiliation of the commentator. In general, the $360,000 was probably less than reasonable compensation for Edwards (less than 2 percent of his legal fees), and the IRS could deem any distributions (i.e., recharacterize them) to be wages subject to the FICA and FUTA taxes.

Even one of Edwards's defenders said that if these funds were distributed to him, he "was making use of an alleged 'tax shelter' and the IRS would be quite justified in treating the distributions as salary." Another commentator said that it was somewhat hypocritical for Edwards to express concern about the solvency of Medicare and Social Security when he had engaged in what seemed to be an attempt to evade the Medicare tax.

corporation makes the short-year election, Cindy is allocated $70,000 of the loss. The sales price of the stock probably would be increased to recognize the tax benefits being transferred from Alicia to Cindy. ■

Tax Planning Strategies

Salary Structure

FRAMEWORK FOCUS: TAX RATE

Strategy: Shift Net Income from High-Bracket Taxpayers to Low-Bracket Taxpayers. Avoid Double Taxation.

The amount of salary paid to a shareholder-employee of an S corporation can have varying tax consequences and should be considered carefully. Larger amounts might be advantageous if the maximum contribution allowed under the retirement plan has not been reached. Smaller amounts may be beneficial if the parties are trying to shift taxable income to lower-bracket shareholders, reduce payroll taxes, curtail a reduction of Social Security benefits, or restrict losses that do not pass through because of the basis limitation.

A strategy of decreasing compensation and correspondingly increasing distributions to shareholder-employees often results in substantial savings in employment taxes. However, a shareholder of an S corporation cannot always perform substantial services and arrange to receive distributions rather than compensation so that the corporation may avoid paying employment taxes. The shareholder may be deemed an employee, and any distributions will be recharacterized as wages subject to FICA and FUTA taxes.[32] For planning purposes, some level of compensation should be paid to all shareholder-employees to avoid any recharacterization of distributions as deductible salaries—especially in personal service corporations.

Use of S corporations as an income-shifting device within a family (e.g., through a gift of stock from a high-marginal-rate taxpayer to a low-marginal-rate taxpayer) may be ineffective. The IRS can ignore such transfers unless the stock is purchased at fair market value.[33] Effectively, the IRS can require that reasonable compensation be paid to family members who render services or provide capital to the S corporation.

[32]Rev.Rul. 74–44, 1974–1 C.B. 287; *Spicer Accounting, Inc. v. U.S.*, 91–1 USTC ¶50,103, 66 AFTR 2d 90–5806, 918 F.2d 90 (CA–9, 1990); *Radtke v. U.S.*, 90–1 USTC ¶50,113, 65 AFTR 2d 90–1155, 895 F.2d 1196 (CA–7, 1990).

[33]§ 1366(e) and Reg. § 1.1373–1(a).



CONCEPT SUMMARY 12.1

Distributions from an S Corporation

Where Earnings and Profits Exist	Where No Earnings and Profits Exist
1. Distributions are tax-free to the extent of the AAA.*	
2. Any PTI from pre-1983 tax years can be distributed tax-free.	
3. The remaining distribution constitutes dividend income from AEP.†	
4. Distributions are tax-free to the extent of the other adjustments account (OAA).	
5. Any residual amount is applied as a tax-free reduction in basis of stock.	1. Distributions are nontaxable to the extent of shareholder's basis in stock.
6. Excess is treated as gain from a sale or exchange of stock (capital gain in most cases).	2. Excess is treated as gain from a sale or exchange of stock (capital gain in most cases).

*A shareholder's stock basis serves as a limit on the amount that may be received tax-free.
†The AAA bypass election is available to pay out AEP before reducing the AAA [§ 1368(e)(3)].

TAX TREATMENT OF DISTRIBUTIONS TO SHAREHOLDERS

LO.5

Determine how distributions to S corporation shareholders are taxed.

S corporations do not generate E & P while the S election is in effect. Indeed, all profits are taxed in the year earned, as though they were distributed on a pro rata basis to the shareholders. Thus, distributions from S corporations do not constitute dividends in the traditional sense—there is no corporate E & P to distribute.

It is possible, however, for S corporations to have an accumulated E & P (AEP) account. This can occur when:

- the S corporation was previously a C corporation, or
- a C corporation with its own AEP merged into the S corporation.

Distributions from S corporations are measured as the cash received plus the fair market value of any other distributed property. The tax treatment of distributions differs, depending upon whether the S corporation has AEP.

S Corporation with No AEP

If the S corporation has no AEP, the distribution is a tax-free recovery of capital to the extent that it does not exceed the basis of the shareholder's stock. When the amount of the distribution exceeds the stock basis, the excess is treated as a gain from the sale or exchange of property (capital gain in most cases).

EXAMPLE 13

Hyacinth, Inc., a calendar year S corporation, has no AEP. During the year, Juan, an individual shareholder of the corporation, receives a cash distribution of $12,200 from Hyacinth. Juan's basis in his stock is $9,700. Juan recognizes a capital gain of $2,500, the excess of the distribution over the stock basis ($12,200 – $9,700). The remaining $9,700 is tax-free, but it reduces Juan's basis in his stock to zero. ■

S Corporation with AEP

For S corporations with AEP, a more complex set of rules applies. These rules blend the entity and conduit approaches to taxation, treating distributions of pre-election (C corporation) and postelection (S corporation) earnings differently. Distributions of C corporation AEP are taxed as dividends (0/15 percent rate), while distributions of previously taxed S corporation earnings are tax-free to the extent of the shareholder's basis in the stock.

The treatment of distributions is determined by their order. Specifically, distributions are deemed to be first from previously taxed, undistributed earnings of the

S corporation. Such distributions are tax-free and are determined by reference to a special account, the **accumulated adjustments account (AAA)**.[34] Next, AEP is distributed as taxable dividends (i.e., as payments from AEP). After AEP is depleted, distributions are made from the **other adjustments account (OAA)**. These amounts are received tax-free by the shareholder. Remaining amounts of the distribution are received tax-free to the extent of the shareholder's remaining stock basis,[35] with any excess being treated typically as capital gain.

EXAMPLE 36

Salvia, a calendar year S corporation, distributes $1,300 of cash to its only shareholder, Otis, on December 31. Otis's basis in his stock is $1,400, AAA is $500, and the corporation has AEP of $750 before the distribution.

The first $500 of the distribution is a tax-free recovery of basis from the AAA. The next $750 is a taxable dividend distribution from AEP. Finally, the remaining $50 of cash is a tax-free recovery of basis. Immediately after the distribution, Salvia has a zero balance in AAA and AEP. Otis's stock basis now is $850.

	Corporate AAA	Corporate AEP	Otis's Stock Basis
Beginning balance	$ 500	$ 750	$1,400
Distribution from AAA	(500)		(500)
Distribution from AEP		(750)	
Distribution from stock basis			(50)
Ending balance	$ –0–	$ –0–	$ 850

■

EXAMPLE 37

Assume the same facts as in the preceding example. The next year, Salvia has no earnings and distributes $1,000 to Otis. Of the distribution, $850 is a tax-free recovery of the stock basis, and then $150 is taxed to Otis as a capital gain. ■

With the consent of all of its shareholders, an S corporation can elect to have a distribution treated as if it were made from AEP rather than from the AAA. This mechanism is known as an **AAA bypass election**. This election may be desirable when making distributions to move the entity to the no-AEP system of accounting for distributions, at a maximum tax cost of 15 percent of the AEP.

EXAMPLE 38

Rotor is a valid S corporation. It has $50 of AEP. An AAA bypass election for Rotor's next shareholder distribution would eliminate the need to track the AAA and would greatly simplify the accounting for future distributions. The cost for this simplification is the tax on $50 of dividend income. ■

Accumulated Adjustments Account

The AAA is the cumulative total of undistributed nonseparately and separately stated income and deduction items for S corporation years beginning after 1982. As noted above, it provides a mechanism to ensure that earnings of an S corporation are taxed only once. Changes to the AAA are reported annually in Schedule M–2 on page 4 of the Form 1120S.

AAA is zero when an S election is made. AAA then is computed at the end of each tax year rather than at the time of a distribution. First, add to the year's beginning balance any current nonseparately computed income and positive separately stated items (except tax-exempt income). Next, account for distributions *prior* to subtracting the negative items.

[34] For S corporations in existence prior to 1983, an account similar to the AAA was used. This account, called *previously taxed income* (PTI), can be distributed in cash tax-free to shareholders after AAA has been distributed. See §§ 1368(c)(1) and (e)(1).

[35] § 1368(c).

EXHIBIT 12.1 Adjustments to the Corporate AAA

Increase by:

1. Schedule K income items other than tax-exempt income.
2. Nonseparately computed income.

Decrease by:

1. Distribution(s) from AAA (but not below zero).
2. Negative separately stated items other than distributions (e.g., losses, deductions).

AAA is applied to the distributions made during the year on a pro rata basis (in a fashion similar to the application of current E & P, discussed in Chapter 10). The determination of AAA is summarized in Exhibit 12.1.

Although adjustments to AAA and stock basis adjustments are similar, there are some important differences between the two amounts. In particular,

- The AAA is not affected by tax-exempt income and related expenses.
- Unlike stock basis, the AAA can have a negative balance. All losses decrease the AAA balance, even those in excess of the shareholder's basis. However, distributions may not make the AAA negative or increase a negative balance in the account.
- Every shareholder has a proportionate interest in the AAA, regardless of the amount of his or her stock basis.[36] In fact, AAA is a corporate account, so there is no connection between the amount and any specific shareholder.[37] Thus, the benefits of AAA can be shifted from one shareholder to another. For example, when an S corporation shareholder sells stock to another party, any AAA balance on the purchase date can be distributed tax-free to the purchaser.

Other Adjustments Account

The OAA tracks the entity's net items that affect basis but not the AAA, such as tax-exempt income and any related nondeductible expenses. Distributions are made from the OAA after AEP and the AAA are reduced to zero. Distributions from this account are tax-free.

Schedule M–2

Page 4 of the Form 1120S includes Schedule M–2, a reconciliation of beginning and ending balances in the AAA, PTI, and OAA accounts. Most tax professionals recommend that the Schedule M–2 be kept current even if the entity has retained no AEP, so that if future events require the use of these amounts, they need not be reconstructed after the fact.

EXAMPLE 19

Poinsettia, an S corporation, records the following items.

AAA, beginning of year	$ 8,500
OAA, beginning of year	–0–
Ordinary income	25,000
Tax-exempt interest	4,000
Key employee life insurance proceeds received	5,000
Payroll penalty expense	2,000
Charitable contributions	3,000
Unreasonable compensation	5,000
Premiums on key employee life insurance	2,100
Distributions to shareholders	16,000

[36] § 1368(c).

[37] § 1368(e)(1)(A).

Poinsettia's Schedule M–2 appears as follows.

Schedule M-2 Analysis of Accumulated Adjustments Account, Other Adjustments Account, and Shareholders' Undistributed Taxable Income Previously Taxed

		(a) Accumulated adjustments account	(b) Other adjustments account
1	Balance at beginning of tax year	8,500	0
2	Ordinary income from page 1, line 21	25,000	
3	Other additions		9,000**
4	Loss from page 1, line 21	( )	
5	Other reductions	(10,000*)	(2,100)
6	Combine lines 1 through 5	23,500	6,900
7	Distributions other than dividend distributions	16,000	
8	Balance at end of tax year. Subtract line 7 from line 6	7,500	6,900

*$2,000 (payroll penalty) + $3,000 (charitable contributions) + $5,000 (unreasonable compensation).

**$4,000 (tax-exempt interest) + $5,000 (life insurance proceeds). ■

DIGGING DEEPER 5

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

Effect of Terminating the S Election

Normally, distributions to shareholders from a C corporation are taxed as dividends to the extent of E & P. However, any distribution of *cash* by a C corporation to shareholders during a one-year period[38] following an S election termination receives special treatment. Such a distribution is treated as a tax-free recovery of stock basis to the extent that it does not exceed the AAA.[39] Since *only* cash distributions reduce the AAA during this *postelection termination period*, a corporation should not make property distributions during this time. Instead, the entity should sell property and distribute the proceeds to shareholders.

EXAMPLE 20

Quinn, the sole shareholder of Azalea, Inc., a calendar year S corporation, decides during 2010 to terminate the S election, effective January 1, 2011. As of the end of 2010, Azalea has a balance in the AAA of $1,300. Quinn can receive a nontaxable distribution of cash during the post-termination period to the extent of Azalea's AAA. Cash distributions of $1,300 during 2011 are nontaxable to Quinn, but they reduce the basis of his stock. ■

Tax Planning Strategies THE ACCUMULATED ADJUSTMENTS ACCOUNT

FRAMEWORK FOCUS: TAX RATE

Strategy: Avoid Double Taxation.

The AAA is needed to determine the tax treatment of distributions from S corporations with AEP *and* distributions made during the post-termination election period. Therefore, it is important for all S corporations (even those with no AEP) to maintain a current AAA (and OAA) balance. Without an accurate AAA balance, distributions could needlessly be classified as taxable dividends. Alternatively, it will be costly to reconstruct the AAA after the S election terminates.

Distributions should be made when AAA is positive. If future years bring operating losses, AAA is reduced, and shareholder exposure to AEP and taxable dividends increases.

[38] § 1377(b).

[39] § 1371(e). Termination-period distributions from the OAA are not exempt. They are taxed as capital gain.

CONCEPT SUMMARY 12.2

Consequences of Noncash Distributions

	Appreciated Property	Depreciated Property
S corporation	Realized gain is recognized by the corporation, which passes it through to the shareholders. Such gain increases a shareholder's stock basis, generating a basis in the property equal to FMV. On the distribution, the shareholder's stock basis is reduced by the FMV of the property (but not below zero).	Realized loss is not recognized. The shareholder assumes an FMV basis in the property.
C corporation	Realized gain is recognized under § 311(b) and increases E & P (net of tax). The shareholder has a taxable dividend to the extent of E & P. The basis in the property equals its FMV.	Realized loss is not recognized. The shareholder assumes an FMV basis in the property.
Partnership	No gain to the partnership or partner. The partner takes a carryover basis in the asset, but the asset basis is limited to the partner's basis in the partnership.	Realized loss is not recognized. The partner takes a carryover basis in the asset, but the asset basis is limited to the partner's basis in the partnership.

TAX TREATMENT OF NONCASH DISTRIBUTIONS BY THE CORPORATION

An S corporation recognizes a gain on a liquidating or nonliquidating distribution of appreciated property in the same manner as if the asset had been sold to the shareholder at its fair market value.[40] The corporate gain is passed through to the shareholders. There is an important reason for this rule. Without it, property might be distributed tax-free (other than for certain recapture items) and later sold without income recognition to the shareholder because the shareholder's basis equals the asset's fair market value. The character of the gain—capital gain or ordinary income—depends upon the type of asset being distributed.

The S corporation does not recognize a loss when distributing assets that are worth less than their basis. As with gain property, the shareholder's basis is equal to the asset's fair market value. Thus, the potential loss is postponed until the shareholder sells the stock of the S corporation. Since loss property receives a step-down in basis without any loss recognition by the S corporation, distributions of loss property should be avoided. See Concept Summary 12.2.

EXAMPLE 11

Yarrow, Inc., an S corporation for 10 years, distributes a tract of land held as an investment to one of its shareholders. The land was purchased for $22,000 many years ago and is currently worth $82,000. Yarrow recognizes a capital gain of $60,000, which increases the AAA by $60,000. The gain flows through proportionately to Yarrow's shareholders and is taxed to them.

Then a tax-free property distribution reduces AAA and shareholder stock basis by $82,000 (fair market value). The tax consequences are the same for appreciated property, whether it is distributed to the shareholders and they dispose of it, or the corporation sells the property and distributes the proceeds to the shareholders. ■

[40] § 311(b).

EXAMPLE 23

Continue with the facts of Example 21. If the land had been purchased for $82,000 and was currently worth $22,000, the shareholder would take a $22,000 basis in the land. The $60,000 realized loss is not recognized at the corporate level. The loss does not reduce Yarrow's AAA. Only when the S corporation sells the asset does it recognize the loss and reduce AAA. ■

EXAMPLE 24

Assume the same facts as in Examples 21 and 22, except that Yarrow is a C corporation (E & P balance of $1 million) or a partnership. Assume the partner's basis in the partnership interest is $100,000 and ignore any corporate-level taxes. Compare the results.

	Appreciated Property		
	S Corporation	C Corporation	Partnership
Entity gain/loss	$60,000	$60,000	$ –0–
Owner's gain/loss/dividend	60,000	82,000	–0–
Owner's basis in land	82,000	82,000	22,000

	Property That Has Declined in Value		
	S Corporation	C Corporation	Partnership
Entity gain/loss	$ –0–	$ –0–	$ –0–
Owner's gain/loss/dividend	–0–	22,000	–0–
Owner's basis in land	22,000	22,000	82,000

■

LO.6

Calculate a shareholder's basis in S corporation stock.

SHAREHOLDER'S BASIS

The calculation of the initial tax basis of stock in an S corporation is similar to that for the basis of stock in a C corporation and depends upon the manner in which the shares are acquired (e.g., gift, inheritance, purchase, exchange under § 351). Once the initial tax basis is determined, various transactions during the life of the corporation affect the shareholder's basis in the stock. Although each shareholder is required to compute his or her own basis in the S shares, neither Form 1120S nor Schedule K–1 provides a place for tracking this amount.

A shareholder's basis is increased by stock purchases and capital contributions. Operations during the year cause the following additional upward adjustments to basis.[41]

- Nonseparately computed income.
- Separately stated income items (e.g., nontaxable income).

Basis then is reduced by distributions not reported as income by the shareholder (e.g., an AAA or PTI distribution). Next, the following items reduce basis (but not below zero).

- Nondeductible expenses of the corporation (e.g., fines, penalties, illegal kickbacks).
- Nonseparately computed loss.
- Separately stated loss and deduction items.

As under the partnership rules, basis first is increased by income items; then it is decreased by distributions and finally by losses.[42] In most cases, this *losses last* rule is advantageous.

[41] § 1367(a). [42] Reg. § 1.1367–1(f).

In its first year of operations, Iris, Inc., a calendar year S corporation, earns income of $2,000. As a result, the stock basis of Iris's sole shareholder, Marty, is increased to $2,000. On February 2 in its second year of operations, Iris distributes $2,000 to Marty. During the remainder of the second year, the corporation incurs a $2,000 loss.

Under the S corporation ordering rules, the $2,000 distribution is tax-free AAA to Marty. The distribution is accounted for before the loss. The $2,000 loss is *not* passed through, though, because stock basis cannot be reduced below zero. ■

A shareholder's basis in S corporation stock never is reduced below zero. Once stock basis is zero, any additional basis reductions (losses or deductions, but *not* distributions) decrease (but not below zero) the shareholder's basis in loans made to the S corporation. Any excess of losses or deductions over both stock and loan bases is not deductible in the current year. Losses can be deducted only to the extent that they offset stock or loan basis. Thus, until additional basis is created due to capital contributions or flow-through income, the loss deductions are suspended.

When there is a capital contribution or an item of flow-through income, basis is first restored to the shareholder loans, up to the original principal amount.[43] Then, basis in the stock is restored.

Stacey, a sole shareholder, has a $7,000 stock basis and a $2,000 basis in a loan that she made to a calendar year S corporation with zero AEP. At the beginning of the year, the corporation's AAA and OAA balances are $0. Subchapter S ordinary income for the year is $8,200. During the year, the corporation also received $2,000 of tax-exempt interest income.

Cash of $17,300 is distributed to Stacey on November 15. As a result, Stacey recognizes only a $100 capital gain.

	Corporate AAA	Corporate OAA	Stacey's Stock Basis	Stacey's Loan Basis
Beginning balance	$ –0–	$ –0–	$ 7,000	$2,000
Ordinary income	8,200		8,200	
Tax-exempt income		2,000	2,000	
Subtotal	$ 8,200	$ 2,000	$17,200	$2,000
Distribution ($17,300)				
From AAA	(8,200)		(8,200)	
From OAA		(2,000)	(2,000)	
From stock basis			(7,000)	
Ending balance	$ –0–	$ –0–	$ –0–	$2,000
Distribution in excess of stock basis (capital gain)			$ 100	

Pass-through losses can reduce loan basis, but distributions do not. Stock basis cannot be reduced below zero, and the $100 excess distribution does not reduce Stacey's loan basis. ■

The basis rules for S corporation stock are similar to the rules for determining a partner's basis in a partnership interest. However, a partner's basis in the partnership interest includes the partner's direct investment plus a *ratable share* of partnership liabilities.[44] If a partnership borrows from a partner, the partner receives a basis increase as if the partnership had borrowed from an unrelated third party.[45] In contrast, corporate borrowing has no effect on the stock basis of an S corporation shareholder. Loans from a shareholder to the S corporation have a tax basis only for the shareholder making the loan.

[43] § 1367(b)(2); Reg. § 1.1367–2(e).

[44] § 752(a).

[45] Reg. § 1.752–1(e).

If a loan's basis has been reduced and is not restored, income is recognized when the corporation repays the loan. If the corporation issued a note as evidence of the debt, repayment constitutes an amount received in exchange for a capital asset, and the amount that exceeds the shareholder's basis is capital gain.[46] However, if the loan is made on open account, the repayment constitutes ordinary income to the extent that it exceeds the shareholder's basis in the loan. Thus, a note should be given to ensure capital gain treatment for the income that results from a loan's repayment.

EXAMPLE 25

Phil is the sole shareholder of Falcon, a valid S corporation. At the beginning of 2010, Phil's basis in his stock was $10,000. During 2010, he made a $4,000 loan to the corporation, using a written debt instrument and market interest rates.

Falcon generated a $13,000 taxable loss for 2010. Thus, at the beginning of 2011, Phil's stock basis was zero, and the basis in his loan to Falcon was $1,000.

Falcon repaid the loan in full on March 1, 2011. Phil recognized a $3,000 capital gain on the repayment. ■



In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

Tax Planning Strategies **WORKING WITH SUSPENDED LOSSES**

FRAMEWORK FOCUS: INCOME AND EXCLUSION

Strategy: Avoid Income Recognition.

Distributions made to shareholders with suspended losses usually create capital gain income because there is no stock basis to offset. Usually, distributions should be deferred until the shareholder creates stock basis in some form. In this way, no gross income is recognized until the suspended losses are fully used.

EXAMPLE 26

Continue with the facts of Example 26 except that Falcon's loss cannot be deducted by Phil because of the lack of basis. Phil purchases $5,000 of additional stock in Falcon. Phil gets an immediate deduction for his investment, due to his $13,000 in suspended losses. Alternatively, if Falcon shows a $5,000 profit for the year, Phil pays no tax on the flow-through income, due to his $13,000 in suspended losses.

However, if Falcon distributes $5,000 to Phil in 2011 without earning any profit for the year, and prior to any capital contribution by him, Phil recognizes a $5,000 capital gain, because his stock basis is zero. ■

LO.7

Explain the tax effects of losses on S shareholders.

TREATMENT OF LOSSES

Net Operating Loss

One major advantage of an S election is the ability to pass through net operating losses (NOLs) of the corporation directly to the shareholders. A shareholder can deduct an NOL for the year in which the S corporation's tax year ends. The corporation is not entitled to any deduction for the NOL. A shareholder's basis in the stock is reduced to the extent of any pass-through of the NOL, and the shareholder's AAA is reduced by the same deductible amount.[47]

[46] *Joe M. Smith*, 48 T.C. 872 (1967), *aff'd* and *rev'd* in 70–1 USTC ¶9327, 25 AFTR 2d 70–936, 424 F.2d 219 (CA–9, 1970); Rev.Rul. 64–162, 1964–1 C.B. 304. An open account loan is treated as evidenced by a note if the shareholder's net payable at the end of the tax year exceeds $25,000. Reg. § 1.1367–2.

[47] §§ 1368(a)(1)(A) and (e)(1)(A).

Deductions for an S corporation's pass-throughs (e.g., NOL, capital loss, charitable contributions) cannot exceed a shareholder's stock basis *plus* the basis of any loans made by the shareholder to the corporation.[48] A shareholder is entitled to carry forward a loss pass-through to the extent that the loss for the year exceeds basis. Any pass-through carried forward may be deducted *only* by the *same* shareholder if and when the basis in the stock of or loans to the corporation is restored.[49]

EXAMPLE 30

Ginny owns 10% of the stock of Pilot, a calendar year S corporation. Her basis in the shares is $10,000 at the beginning of 2009. The indicated events are accounted for under the S corporation rules as follows.

Tax Year	Event	Tax Consequences
2009	Ginny's share of Pilot's operating loss is $15,000.	Ginny deducts $10,000. Her stock basis is reduced to zero. She holds a $5,000 suspended loss.
2010	Ginny's share of Pilot's operating loss is $4,000.	No deduction for the loss, as Ginny has no stock basis to offset. Her suspended loss is now $9,000.
2011	Ginny's share of Pilot's operating loss is $7,000. She purchases an additional $10,000 of stock from Pilot.	The purchase creates $10,000 of stock basis. Ginny deducts $10,000—the current $7,000 loss and $3,000 of the suspended loss. Stock basis again is zero, and the new suspended loss is $6,000.
2012	Ginny sells all of her Pilot shares to Christina on January 1.	The $6,000 suspended loss disappears—it cannot be transferred to Christina.

■

Tax Planning Strategies Loss Considerations

FRAMEWORK FOCUS: DEDUCTIONS

Strategy: Maximize Deductible Amounts.

A loss in excess of tax basis may be carried forward and deducted only by the same shareholder in succeeding years. Thus, before disposing of the stock, a shareholder should increase stock/loan basis to flow through the loss. The next shareholder cannot acquire the loss carryover.

The NOL provisions create a need for sound tax planning during the last election year and the post-termination transition period. If it appears that the S corporation is going to sustain an NOL or use up any loss carryover, each shareholder's basis should be analyzed to determine if it can absorb the owner's share of the loss. If basis is insufficient to absorb the loss, further investments should be considered before the end of the post-termination period. Such investments can be accomplished through additional stock purchases from the corporation, or from other shareholders, to increase basis.

EXAMPLE 31

A calendar year C corporation has an NOL of $20,000 in 2009. The corporation makes a valid S election in 2010 and has another $20,000 NOL in that year. At all times during 2010, the stock of the corporation was owned by the same 10 shareholders, each of whom owned 10% of the stock. Tim, one of the shareholders, has a stock basis of $1,800 at the beginning of 2010. None of the 2009 NOL may be carried forward into the S year. Although Tim's share of the 2010 NOL is $2,000, his deduction for the loss is limited to $1,800 in 2010 with a $200 carryover to 2011. ■

[48] See *Donald J. Sauvigne*, 30 TCM 123, T.C.Memo. 1971–30.

[49] § 1366(d).

At-Risk Rules

S corporation shareholders, like partners, are limited in the amount of loss that they may deduct by their "at-risk" amounts. The rules for determining at-risk amounts are similar, but not identical, to the partnership at-risk rules.

An amount at risk is determined separately for each shareholder. The amount of the corporate losses that are passed through and deductible by the shareholders is not affected by the amount the corporation has at risk. A shareholder usually is considered at risk with respect to an activity to the extent of cash and the adjusted basis of other property contributed to the electing corporation, any amount borrowed for use in the activity for which the taxpayer has personal liability for payment from personal assets, and the net fair market value of personal assets that secure nonrecourse borrowing.

Any losses that are suspended under the at-risk rules are carried forward and are available during the post-termination period. The S stock basis limitations and at-risk limitations are applied before the passive activity limitations (see below).

EXAMPLE 35

Carl has a basis of $35,000 in his S corporation stock. He takes a $15,000 nonrecourse loan from a relative and lends the proceeds to the S corporation. Carl now has a stock basis of $35,000 and a loan basis of $15,000. However, due to the at-risk limitation, he can deduct only $35,000 of losses from the S corporation. ■

Passive Losses and Credits

Net passive losses and credits are not deductible when incurred and must be carried over to a year when there is passive income. Thus, one must be aware of three major classes of income, losses, and credits—active, portfolio, and passive. S corporations are not directly subject to the passive activity limits, but corporate rental activities are inherently passive, and other activities of an S corporation may be passive unless the shareholder(s) materially participate(s) in operating the business. An S corporation may engage in more than one such activity.

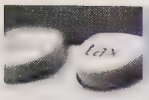
If the corporate activity involves rentals or the shareholders do not materially participate, any passive loss or credit that flows through is passive. The shareholders can apply such losses or credits only against income from other passive activities. An S shareholder's stock basis is reduced by passive losses that flow through to the shareholder, even though the shareholder may not be entitled to a current deduction due to the passive loss limitations.

OTHER OPERATIONAL RULES

Several other points may be made about the possible effects of various Code provisions on S corporations.

- An S corporation must make estimated tax payments with respect to any recognized built-in gain and excess passive investment income tax (discussed next).
- An S corporation may own stock in another corporation, but an S corporation may not have a C corporation shareholder. An S corporation is *not* eligible for the dividends received deduction.
- An S corporation is *not* subject to the 10 percent of taxable income limitation applicable to charitable contributions made by a C corporation.
- Any family member who renders services or furnishes capital to an S corporation must be paid reasonable compensation. Otherwise, the IRS can make adjustments to reflect the value of the services or capital. This rule may make it more difficult for related parties to shift Subchapter S taxable income to children or other family members.
- The flow-through of S items to a shareholder is not self-employment income and is not subject to the self-employment tax.[50] Compensation for services rendered to an S corporation is, however, subject to FICA

[50] Rev.Rul. 59–221, 1959–1 C.B. 225.



CONCEPT SUMMARY 12.3

Treatment of S Corporation Losses

Step 1. Allocate total loss to the shareholder on a daily basis, based upon stock ownership.

Step 2. If the shareholder's loss exceeds his or her stock basis, apply any excess to the basis of corporate indebtedness to the shareholder. Loss allocations do not reduce stock or loan basis below zero.

Step 3. Where a flow-through loss exceeds the stock and loan basis, any excess is suspended and carried over to succeeding tax years.

Step 4. In succeeding tax years, any net increase in basis restores the debt basis first, up to its original amount.

Step 5. Once debt basis is restored, any remaining net increase restores stock basis.

If the S election terminates, any suspended loss carryover may be deducted during the post-termination period to the extent of the stock basis at the end of this period. Any loss remaining at the end of this period is lost forever.

taxes. This treatment of earned income of S corporations is attractive compared to the treatment of a proprietorship or a partnership, whose income is taxed as self-employment income to the owners.

- A number of fringe benefits, which normally can be received by employees on a tax-free basis, are subject to tax when received by a more-than-2 percent shareholder-employee of an S corporation. Such benefits include group term life insurance, medical insurance, and meals and lodging furnished for the convenience of the employer. These items are treated as wages and are subject to most payroll taxes. The employee can deduct medical insurance premiums on his or her Form 1040.
- An S corporation is placed on the cash method of accounting for purposes of deducting business expenses and interest owed to a cash basis related party.[51] Thus, the timing of the shareholder's income and the corporate deduction must match.
- With respect to the domestic production activities deduction (DPAD), the S corporation passes through the various amounts needed, and the deduction is computed at the shareholder level. For instance, domestic production gross receipts (DPGR), the corresponding cost of goods sold, and attributable W–2 wages, among other items, are separately stated items reported to the shareholders on a pro rata basis.
- The S election is not recognized by the District of Columbia and several states, including Louisiana, New Hampshire, and Tennessee. Thus, some or all of the entity's income may be subject to a state-level income tax.
- An S corporation may issue § 1244 stock to its shareholders to obtain ordinary loss treatment.
- Losses may be disallowed due to a lack of a profit motive. If the activities at the corporate level are not profit motivated, the losses may be disallowed under the hobby loss rules (see Chapter 17).[52]

12.4 Entity-Level Taxes

LO.8

Compute the entity-level taxes on S corporations.

TAX ON PRE-ELECTION BUILT-IN GAIN

Normally, an S corporation does *not* pay an income tax, since all items flow through to the shareholders. But an S corporation that was previously a C corporation may be required to pay a built-in gains tax, a LIFO recapture tax, a general business credit recapture, or a passive investment income tax.

[51] § 267(b).

[52] *Michael J. Houston*, 69 TCM 2360, T.C.Memo. 1995–159; *Mario G. De Mendoza, III*, 68 TCM 42, T.C.Memo. 1994–314.

CONCEPT SUMMARY 12.4

Calculation of the Built-in Gains Tax Liability

Step 1. Select the smaller of built-in gain or taxable income.*
Step 2. Deduct unexpired NOLs and capital losses from C corporation tax years.
Step 3. Multiply the tax base obtained in step 2 by the top corporate income tax rate.
Step 4. Deduct any business credit carryforwards and AMT credit carryforwards arising in a C corporation tax year from the amount obtained in step 3.
Step 5. The corporation pays any tax resulting in step 4.

*Any net recognized built-in gain in excess of taxable income is carried forward to the next year within the 7- or 10-year recognition period.

Without the **built-in gains tax**, it would be possible to avoid the corporate double tax on a disposition of appreciated property, by electing S corporation status.

EXAMPLE 51

Zinnia, Inc., a C corporation, owns a single asset with a basis of $100,000 and a fair market value of $500,000. If Zinnia sells this asset and distributes the cash to its shareholders, there are two levels of tax, one at the corporate level and one at the shareholder level. Alternatively, if Zinnia distributes the asset to its shareholders as a dividend, a double tax still results.

In an attempt to avoid the double tax, Zinnia elects S corporation status. It then sells the asset and distributes the proceeds to shareholders. Without the built-in gains tax, the gain would be taxed only once, at the shareholder level. The distribution of the sales proceeds would be a tax-free reduction of the stock basis and the AAA. ■

The built-in gains tax generally applies to C corporations converting to S status. It is a *corporate-level* tax on any built-in gain recognized when the S corporation disposes of an asset in a taxable disposition within 10 calendar years after the date on which the S election took effect. The 10-year holding period is reduced to 7 years for tax years beginning in 2009 and 2010.[53] The steps in computing the tax are summarized in Concept Summary 12.4.

General Rules

The base for the built-in gains tax includes any unrealized gain on appreciated assets (e.g., real estate, cash basis receivables, goodwill) held by a corporation on the day it elects S status. The highest corporate tax rate (currently 35 percent) is applied to the unrealized gain when any of the assets are sold. Any gain from the sale (net of the built-in gains tax)[54] also passes through as a taxable gain to shareholders.

EXAMPLE 52

Assume the same facts as in the preceding example. Section 1374 imposes a corporate-level built-in gains tax that must be paid by Zinnia if it sells the asset after electing S status. Upon sale of the asset, the corporation owes a tax of $140,000 ($400,000 × 35%). In addition, the shareholders report a $260,000 taxable gain ($400,000 − $140,000). Hence, the built-in gains tax effectively imposes a double tax on Zinnia and its shareholders. ■

DIGGING DEEPER 7

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

The amount of built-in gain recognized in any year is limited to an *as if* taxable income for the year, computed as if the corporation were a C corporation. Any built-in gain that escapes taxation due to the taxable income limitation is carried forward and recognized in future tax years. Thus, a corporation can defer a built-in gain tax liability whenever it has a low or negative taxable income.

[53] § 1374(d)(7)(B).

[54] § 1366(f)(2).

Vinca's recognized built-in gain for 2010 is $400,000. If Vinca were a C corporation, its 2010 taxable income would be $300,000. The amount of built-in gain subject to tax in 2010 is $300,000. The excess built-in gain of $100,000 is carried forward and taxed in 2011 (assuming adequate C corporation taxable income in that year). There is no statutory limit on the carryforward period, but the gain would effectively expire at the end of the 7- or 10-year recognition period applicable to all built-in gains.[55] ■

Normally, tax attributes of a C corporation do not carry over to a converted S corporation. For purposes of the built-in gains tax, however, certain carryovers are allowed. In particular, an S corporation can offset built-in gains with unexpired NOLs or capital losses from C corporation years.

An S corporation has a built-in gain of $100,000 and taxable income of $90,000. The built-in gains tax liability is calculated as follows, applying the indicated loss carryforwards.

Lesser of taxable income or built-in gain	$ 90,000
Less: NOL carryforward from C year	(12,000)
Capital loss carryforward from C year	(8,000)
Tax base	$ 70,000
Highest corporate income tax rate	× 0.35
Tentative tax	$ 24,500
Less: Business credit carryforward from C year	(4,000)
Built-in gains tax liability	$ 20,500

The $10,000 realized (but not taxed) built-in gain in excess of taxable income is carried forward to the next year, as long as the next year is within the 7- or 10-year recognition period. ■

Tax Planning Strategies MANAGING THE BUILT-IN GAINS TAX

FRAMEWORK FOCUS: INCOME AND EXCLUSION

Strategy: Avoid Income Recognition.
Postpone Recognition of Income to Achieve Tax Deferral.

Although limitations exist on contributions of loss property to the corporation before electing S status, it still is possible for a corporation to minimize built-in gains and maximize built-in losses prior to the S election. A cash basis S corporation can accomplish this by reducing receivables, accelerating payables, and accruing compensation costs.

To further reduce or defer the tax, the corporation may take advantage of the taxable income limitation by shifting income and deductions to minimize taxable income in years when built-in gain is recognized. Although the postponed built-in gain is carried forward to future years, the time value of money makes the postponement beneficial. For example, paying compensation to shareholder-employees in place of a distribution creates a deduction that reduces taxable income and postpones the built-in gains tax.

Tulip, Inc., an S corporation, has built-in gain of $110,000 and taxable income of $120,000 before payment of salaries to its shareholders. If Tulip pays at least $120,000 in salaries to the shareholders (rather than making a distribution), its taxable income drops to zero, and the built-in gains tax is postponed. Thus, Tulip needs to keep the salaries as high as possible to postpone the built-in gains tax in future years and reap a benefit from the time value of money. Of course, paying the salaries may increase the payroll tax burden if the salaries are initially below FICA and FUTA limits. ■

Giving built-in gain property to a charitable organization does not trigger the built-in gains tax.

Built-in *loss* property may be sold in the same year that built-in gain property is sold to reduce or eliminate the built-in gains tax. Generally, the taxpayer should sell built-in loss property in a year when an equivalent amount of built-in gain property is sold. Otherwise, the built-in loss could be wasted.

[55] § 1374(d)(7); Notice 90–27, 1990–1 C.B. 336.

No Double Taxation?

S corporations paid over $600 million in Federal corporate-level taxes for tax year 2006, a significant level of collections from "tax-exempt" entities.

For 2006, corporate-level Federal income taxes were reported by about 7,000 S corporations, about 0.20 percent of all S returns filed.

Federal Income Taxes Paid by S Corporations ($M)	
Built-in gains, LIFO recapture taxes	$584
Passive investment income penalty tax	46
Audit adjustments, other	10
Totals	$640

LIFO Recapture Tax

When a corporation uses the FIFO method for its last year before making the S election, any built-in gain is recognized and taxed as the inventory is sold. A LIFO-basis corporation would not recognize this gain unless the corporation invaded the LIFO layer during the 7- or 10-year built-in gains tax period. To preclude a deferral of gain recognition under LIFO, any LIFO recapture amount at the time of the S election is subject to a corporate-level tax.

The taxable LIFO recapture amount equals the excess of the inventory's value under FIFO over the LIFO value. The resulting tax is payable in four equal installments, with the first payment due on or before the due date for the corporate return for the last C corporation year (without regard to any extensions). The remaining three installments must be paid on or before the due dates of the succeeding corporate returns. No interest is due if payments are made by the due dates, and no estimated taxes are due on the four tax installments. No refund is allowed if the LIFO value is higher than the FIFO value.

EXAMPLE 16

Daffodil Corporation converts from a C corporation to an S corporation at the beginning of 2010. Daffodil used the LIFO inventory method in 2009 and had an ending LIFO inventory of $110,000 (FIFO value of $190,000). Daffodil adds the $80,000 LIFO recapture amount to its 2009 taxable income, resulting in an increased tax liability of $28,000 ($80,000 × 35%). Daffodil pays one-fourth of the tax ($7,000) with its 2009 corporate tax return. The three succeeding installments of $7,000 each are paid with Daffodil's 2010–2012 S corporation tax returns. ■

PASSIVE INVESTMENT INCOME PENALTY TAX

A tax is imposed on the excess passive income of S corporations that possess AEP from C corporation years. The tax rate is the highest corporate income tax rate for the year. The rate is applied to excess net passive income (ENPI), which is determined using the following formula.

$$\text{Excess net passive income} = \frac{\text{Passive investment income in excess of 25\% of gross receipts for the year}}{\text{Passive investment income for the year}} \times \text{Net passive investment income for the year}$$

Passive investment income (PII) includes gross receipts derived from royalties, rents, dividends, interest, and annuities. Only the net gain from the disposition of

capital assets is taken into account in computing PII gross receipts.[56] Net passive income is passive income reduced by any deductions directly connected with the production of that income. Any passive income tax reduces the amount the shareholders must take into income.

The excess net passive income cannot exceed a hypothetical C corporate taxable income for the year, before considering special C corporation deductions (like the dividends received deduction) or an NOL carryover.[57]

EXAMPLE 31

Lilac Corporation, an electing S corporation, has gross receipts totaling $264,000 (of which $110,000 is PII). Expenditures directly connected to the production of the PII total $30,000. Therefore, Lilac has net PII of $80,000 ($110,000 − $30,000), and its PII exceeds 25% of its gross receipts by $44,000 [$110,000 PII − (25% × $264,000)]. Excess net passive income (ENPI) is $32,000, calculated as follows.

$$\text{ENPI} = \frac{\$44,000}{\$110,000} \times \$80,000 = \$32,000$$

Lilac's PII tax is $11,200 ($32,000 × 35%). ■

Tax Planning Strategies AVOID PII PITFALLS

FRAMEWORK FOCUS: TAX RATE

Strategy: Avoid Double Taxation.

Watch for a possible violation of the PII limitation. Avoid a consecutive third year with excess passive income when the corporation has accumulated E & P from C corporation years. In this connection, assets that produce passive income (e.g., stocks and bonds, certain rental assets) might be retained by the shareholders in their individual capacities and kept out of the corporation.



In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

12.5 SUMMARY

The S corporation rules are elective and can be used to benefit a number of owners of small businesses.

- When the business is profitable, the S corporation election removes the threat of double taxation on corporate profits.
- When the business is generating losses, deductions for allocable losses are immediately available to the shareholders.

About two-thirds of all U.S. corporations operate under the S rules. Flow-through income is taxed to the shareholders, who increase basis in their corporate stock accordingly. In this manner, subsequent distributions to shareholders can be made tax-free. Flow-through losses reduce stock and debt basis, but loss deductions are suspended when basis reaches zero. Flow-through items that could be treated differently by various shareholders are separately stated on Schedule K–1 of the Form 1120S.

Corporate-level taxes seldom are assessed on S corporations, but they guard against abuses of the S rules, such as shifting appreciated assets from higher C corporation rates to lower individual rates (the built-in gains tax) or doing the same with investment assets (the tax on excessive PII). The S corporation is liable for a penalty

[56] §§ 1362(d)(3)(B) and (C).

[57] §§ 1374(d)(4), and 1375(a) and (b).

TAX

The S Corporation Economy

Total assets controlled by even the smallest S corporations make up a significant part of the economy. The 4 million S corporations that file Federal tax returns, representing over 6.6 million shareholders, employ $3 trillion in assets in their investments and operations.

Here are some more data about the S corporation sector.

- Trade or business income accounts for about 80 percent of all S corporation net income.
- About two-thirds of all S corporations report a positive amount of gross income.
- More than half of all S corporations report business gross receipts of $250,000 or less.

if it does not file its Form 1120S on a timely basis. The penalty is $195 per month times the number of S shareholders, for up to 12 months.[58]

The S rules are designed for the closely held business with a simple capital structure. Eligibility rules are not oppressive, and they do not include any limitations on the corporation's capitalization value, sales, number or distribution of employees, or other operating measures. Accounting for an S corporation's shareholder distributions can be complex, though, and maintenance of S status must be monitored on an ongoing basis.

REFOCUS ON THE BIG PICTURE

CONVERTING A C CORPORATION TO AN S CORPORATION

As long as Fowle, Inc., is a C corporation, David cannot deduct the losses that the business incurs on his individual tax return. However, the corporation can carry any net operating losses (NOLs) back and claim refunds for prior taxes paid and carry any remaining NOLs forward to reduce taxes paid if the company becomes profitable again.

If David wants to deduct the losses on his individual return, the corporation should make an S election or possibly become an LLC. Assuming that Fowle has only one class of stock outstanding, an S election may be appropriate. The election should be made before any losses are incurred because any regular corporate NOLs do not flow through to the S shareholders.

David should make a timely election on Form 2553, and all shareholders must consent to the election. For the S election to be effective this year, he should make the election on or before the fifteenth day of the third month of the current year.

What If?

What if David expects the loss years to be followed by increased profitability as the company shifts some of its manufacturing to other countries with cheaper labor and material costs? In this case, David expects the corporation to make significant distributions to the shareholders. How might this affect David's decision to make an S election?

David should be aware of several rules that may result in tax being paid by the S corporation or its shareholders. First, distributions from an S corporation may

CONTINUED

[58] § 6699. The penalty is waived if the entity can show reasonable cause for the failure to file.

be treated as taxable dividends to the shareholders to the extent that the S corporation has earnings and profits dating to its years as a C corporation. While distributions are deemed to be made first from accumulated net S corporation earnings, distributions in excess of that amount may be treated as a taxable dividend, being paid from AEP (accumulated E & P).

The S corporation's DPAD computations flow through to David, as does Fowle's tax-exempt interest income. The entity may want to reconsider its salary and fringe benefits levels for David, so as to minimize the creation of self-employment income, and to manage the restrictions on deductions for fringe benefits provided to S shareholders. Fowle's tax-exempt interest can be distributed to David tax-free only after all of the entity's AEP has been accounted for.

In addition, David should be aware that an S corporation that has been a C corporation in the past may be required to pay a built-in gains tax or LIFO recapture tax. The base for the built-in gains tax includes any unrealized gain on appreciated assets held by Fowle, Inc., on the day the company becomes an S corporation. The highest Federal corporate income tax rate is applied to the unrealized gains when any of the assets are sold within a specified number of years. If Fowle uses the LIFO inventory method, any LIFO recapture amount at the time of the S election is subject to a corporate-level tax.

SUGGESTED READINGS

"Employment Agreement Not Deemed to Be Second Class of Stock for an S Corporation," *Journal of Taxation*, August 2009.

"Feds Push for Imposition of Self-Employment Taxes on S Corporations," *Business Entities*, January/February 2010.

Ryan H. Pace, "Debunking the Notion That S Corporations Are Taxed 'Just Like' Partnerships," *Business Entities*, July/August 2007.

James Parker and Claire Y. Nash, "Compensation Planning Concerns Differ for C and S Corporations," *Business Entities*, September/October 2008.

KEY TERMS

AAA bypass election, 12–16

Accumulated adjustments account (AAA), 12–16

Built-in gains tax, 12–26

Other adjustments account (OAA), 12–16

Passive investment income (PII), 12–10

S corporation, 12–2

Small business corporation, 12–4

Subchapter S, 12–2

Voluntary revocation, 12–9

PROBLEMS

1. **LO.1** What are some tax differences between a partnership and an S corporation?

2. **LO.3** On March 2, the two 50% shareholders of a calendar year corporation decide to elect S status. One of the shareholders, Terry, purchased her stock from a previous shareholder (a nonresident alien) on January 18 of the same year. Identify any potential problems for Terry or the corporation.

ISSUE ID

3. **LO.3** Burt is the custodian at Quaker Inn, an S corporation that has paid him bonuses over the years in the form of shares in the corporation. Burt now holds 276 shares in Quaker Inn.

   While listening to a television debate about a national health care plan, Burt decides that the company's health coverage is unfair. He is concerned about this because his wife, Dora, is seriously ill.

ETHICS AND EQUITY

During the second week in December, Burt informs Quaker's president that he would like a Christmas bonus of $75,000 cash, or else he will sell 10 shares of his stock to one of his relatives, a nonresident alien. The resulting loss of the S election would trigger about $135,000 in Federal corporate income taxes for the current year alone. Can you defend Burt's position?

4. **LO.3** Ninety-nine individuals own all of the shares of Woodpecker Corporation. Hal and Mary Jones want to buy into the corporation, and then to direct the entity to make an S election. Can Woodpecker so elect? How many signatures must appear on the consent form making the S election?

5. **LO.2** Which of the following can be a shareholder of an S corporation?
   a. Partnership.
   b. Corporation.
   c. Nonresident alien.
   d. Estate.
   e. Charitable organization exempted from taxation.
   f. IRA.
   g. Minor child.

COMMUNICATIONS

6. **LO.5, 6** Caleb Hudson owns 10% of an S corporation. He is confused with respect to his AAA and stock basis. Write a memo to Caleb identifying the key differences between AAA and his stock basis.

7. **LO.6** For each of the following independent statements, indicate whether the transaction will increase (+), decrease (−), or have no effect (*NE*) on the basis of a shareholder's stock in an S corporation.
   a. Expenses related to tax-exempt income.
   b. Long-term capital gain.
   c. Nonseparately computed loss.
   d. Section 1231 gain.
   e. Depletion *not* in excess of basis.
   f. Separately computed income.
   g. Nontaxable return-of-capital distribution by the corporation.
   h. Selling expenses.
   i. Business gifts in excess of $25.
   j. Depreciation recapture income.
   k. IBM dividends received by the S corporation.
   l. LIFO recapture tax computed on the date of the S election.
   m. Recovery of a bad debt previously deducted.
   n. Short-term capital loss.
   o. Corporate distribution out of AAA.

ISSUE ID

8. **LO.6, 7** Lynch's share of her S corporation's net operating loss is $41,000, but her stock basis is only $29,000. Point out any tax consequences to Lynch.

9. **LO.5, 6** Betty is a shareholder in a calendar year S corporation. At the beginning of the year, her stock basis is $10,000, her share of AAA is $2,000, and her share of corporate AEP is $6,000. She receives a $6,000 distribution, and her share of S corporation items includes a $2,000 long-term capital gain and a $9,000 ordinary loss. Determine the effects of these events on AAA, stock basis, and AEP.

10. **LO.4** The profit and loss statement of Strategy, Inc., an S corporation, shows net profits of $101,000 (book income). The corporation has four equal shareholders. From supplemental data, you obtain the following information about some items that are included in the $101,000.

Selling expenses	($ 19,200)
Municipal bond interest income	2,000
Dividends received on Boeing stock	8,000
§ 1231 gain	6,000
Depreciation recapture income	13,000
Passive income	3,000
Short-term capital loss	(9,000)
Salary paid to owners (each)	(11,000)
Cost of goods sold	(81,000)

a. Determine the nonseparately computed income or loss.
b. What is the portion of ordinary income or loss for Zariat, one of the Strategy shareholders?

11. **LO.5** Polly has been the sole shareholder of a calendar year S corporation since its inception. Polly's stock basis is $15,500, and she receives a distribution of $19,000. Corporate-level accounts are as follows.

AAA ..... $6,000 AEP $500

How is Polly taxed on the distribution?

12. **LO.4** An S corporation's profit and loss statement shows net profits of $101,000 (book income). The corporation has three equal shareholders. From supplemental data, you obtain the following information about some items that are included in the $101,000.

Selling expenses	($21,200)
Municipal bond interest income	2,000
Dividends received on IBM stock	9,000
§ 1231 gain	6,000
Depreciation recapture income	13,000
Short-term capital gain	3,000
Long-term capital loss	(9,000)
Salary paid to owners (each)	(11,000)
Cost of goods sold	(97,000)

Determine nonseparately computed S corporation income or loss.

13. **LO.4** McKain, Inc., a calendar year S corporation, incurs the following items. **ISSUE ID**

Sales	$141,000
Depreciation recapture income	12,000
Short-term capital gain	17,020
Cost of goods sold	(45,000)
Municipal bond interest income	5,000
Administrative expenses	(15,000)
Depreciation expense	(21,000)
Charitable contributions	(12,300)

Calculate McKain's nonseparately computed income.

14. **LO.4, 5** Goblins, Inc., a calendar year S corporation, has $90,000 of AEP. Tobias, the sole shareholder, has an $80,000 basis in his stock with a zero balance in the AAA. **DECISION MAKING**
a. Determine the tax aspects if a $90,000 salary is paid to Tobias.
b. Same as (a), except that Tobias receives a cash distribution of $90,000 from AEP.

15. **LO.4, 5** Palin, Inc., a calendar year S corporation, is owned equally by four shareholders, Alice, Bill, Charles, and Donald. The company owns a plot of land that was purchased for $140,000 three years ago. On November 24, 2010, when the land is worth $220,000, it is distributed to Donald. Assuming Donald's basis in his S corporation stock is $290,000 on the distribution date, what are the tax ramifications?

16. **LO.5, 6** Heather, a 57% owner of an S corporation, has a stock basis of zero at the beginning of the year. Heather's basis in a $28,000 loan made to the S corporation and evidenced by a corporate note has been reduced to zero by pass-through losses. During the year, her net share of corporate ordinary income is $13,000. At the end of the year, Heather receives a $15,000 distribution. Discuss the related income tax consequences.

17. **LO.4** On January 1, Bobby and Alicia own equally all of the stock of an electing S corporation called Prairie Dirt Delight. The company has a $60,000 loss for the year (not a leap year). On the 219th day of the year, Bobby sells his half of the stock to his son, Bubba. How much of the $60,000 loss, if any, is allocated to Bubba?

18. **LO.4, 7** A calendar year S corporation has an ordinary loss of $80,000 and a capital loss of $20,000. Ms. Muhammad owns 30% of the corporate stock and has a $24,000 basis in her stock. Determine the amounts of the ordinary loss and capital loss, if any, that flow through to Ms. Muhammad. Prepare a tax memo for the files, summarizing your position. **COMMUNICATIONS**

19. **LO.5** Money, Inc., a calendar year S corporation, has two unrelated shareholders, each owning 50% of the stock. Both shareholders have a $400,000 stock basis as of January 1, and Money has AAA of $300,000 and AEP of $600,000. During the year, Money has operating income of $100,000. At the end of the year, Money distributes securities worth $1 million, with an adjusted basis of $800,000. Determine the tax effects of these transactions.

DECISION MAKING

20. **LO.5** Assume the same facts as in Problem 19, except that the two shareholders consent to an AAA bypass election (i.e., to distribute AEP first).

21. **LO.4, 6** Valence Corporation's Form 1120S shows ordinary income of $88,000 for the year. Daniel owns 40% of the Valence stock throughout the year. The following information is obtained from the corporate records.

Salary paid to Daniel	($ 40,000)
Tax-exempt interest income	5,000
Charitable contributions	(6,000)
Dividends received from a non-U.S. corporation	5,000
Long-term capital loss	(6,000)
Depreciation recapture income	11,000
Refund of prior-year state income taxes	5,000
Cost of goods sold	(80,000)
Short-term capital loss	(7,000)
Administrative expenses	(18,000)
Short-term capital gain	14,000
Selling expenses	(11,000)
Daniel's beginning stock basis	32,000
Daniel's additional stock purchases	9,000
Beginning AAA	45,000
Daniel's loan to corporation	20,000

a. Compute Valence's book income or loss.
b. Compute Daniel's ending stock basis.
c. Calculate ending corporate AAA.

22. **LO.4, 6, 7** Cloris owns 35% of the stock of Jacket, Inc., an S corporation, and she lends the corporation $7,000 during the year. Her stock basis in the Jacket stock at the end of the year is $25,000. If Jacket sustains a $110,000 operating loss during the year, what amount, if any, can Cloris deduct with respect to the pass-through loss?

COMMUNICATIONS

23. **LO.4, 6, 7** Candy owns 40% of the stock of Park, Inc., an S corporation. Her stock basis is $25,000, and she loaned $10,000 to the corporation during the year. How much of Park's $100,000 operating loss can Candy deduct for this year? Show your computation of the tax consequences in spreadsheet form and include them in a memo to your manager.

24. **LO.5, 6** Chris Valletta, the sole shareholder of Taylor, Inc., elects to terminate the S election, effective at the end of 2010. As of the end of 2010, Taylor, Inc., has AAA of $80,000 and OAA of $15,000. Then Chris received a cash distribution of $100,000 on January 15, 2011. If his stock basis was $220,000 before the distribution, calculate his taxable amount and his ending stock basis.

25. **LO.7** Cardinal, Inc., an S corporation, reports a $102,000 operating loss during the year (not a leap year). At the beginning of the year, Barbara and Sally each own one-half of the stock. On the 102nd day of the year, Barbara sells her half of the stock to Jacob. How much of Cardinal's ordinary loss flows through to Barbara?

26. **LO.6** Jeff, a 52% owner of an S corporation, has a stock basis of zero at the beginning of the year. Jeff's basis in a $10,000 loan made to the corporation and evidenced by a corporate note has been reduced to zero by pass-through losses. During the year, his net share of the corporate taxable income is $11,000. At the end of the year, Jeff receives a $15,000 distribution. Discuss the tax effects of the distribution.

27. **LO.6** Assume the same facts as in Problem 26, except that there is no $15,000 distribution, but the corporation repays the loan principal to Jeff. Discuss the tax effects.

28. **LO.6** Assume the same facts as in Problem 26, except that Jeff's share of corporate taxable income is only $8,000, and there is no distribution. However, the corporation repays the $10,000 loan principal to Jeff. Discuss the tax effects. Assume there was no corporate note (i.e., only an account payable). Does this change your answer?

29. **LO.8** Sonny, Inc., an S corporation in Polly Beach, South Carolina, has a recognized built-in gain of $95,000 and taxable income of $80,000. It holds a $7,000 NOL carryforward and a $9,000 business credit carryforward from a C corporation year. There are no earnings and profits from C corporation years. Calculate Sonny's built-in gains tax liability.

30. **LO.8** Lejeune, Inc., an S corporation in Boone, North Carolina, reports operating revenues of $400,000, taxable interest of $380,000, operating expenses of $250,000, and deductions attributable to the interest income of $140,000. Lejeune's accumulated E & P amounts to $2 million. Calculate any penalty tax payable by Lejeune or its shareholders.

31. **LO.4, 5, 6** Friedman, Inc., an S corporation, holds some highly appreciated land and inventory, and some marketable securities that have declined in value. It anticipates a sale of these assets and a complete liquidation of the company over the next two years. Arnold Schwartz, the CFO, calls you, asking how to treat these transactions. Prepare a tax memo indicating what you told Arnold in the phone conversation.

ISSUE ID

COMMUNICATIONS

32. **LO.6, 7** Robin, Inc., a calendar C corporation in Gainesville, Florida, elects S status for 2010. The company generated a $54,000 NOL in 2009 and an NOL of $34,000 in 2010. At all times in 2009 and 2010, the stock of the corporation is owned by the same 10 shareholders, each of whom holds 10% of the stock. Irv, one of the 10 shareholders, has a stock basis of $2,400 at the beginning of 2010. Discuss any tax aspects for Irv.

DECISION MAKING

33. **LO.6** Claude Bergeron sold 1,000 shares of Ditta, Inc., an S corporation located in Concord, North Carolina, for $9,000. He has a stock basis of $107,000 in the shares. Assuming that Claude is single and that he is the original owner of these § 1244 stock shares, calculate the appropriate tax treatment of any gain or loss. If he sold the stock for $201,000, could he obtain a 50% or 75% exclusion under § 1202 for one-half of the gain?

CRITICAL THINKING

34. **LO.4, 5** Gert is the owner of all of the shares of an S corporation. Gert is considering receiving a salary of $80,000 from the business. She will pay 7.65% FICA taxes on the salary, and the S corporation will pay the same amount of FICA tax. If Gert reduces her salary to $60,000 and takes an additional $20,000 as a distribution, how much total tax could be saved?

CRITICAL THINKING

DECISION MAKING

35. **LO.1** One of your clients, Texas, Inc., is considering electing S status. Both of Texas's equal shareholders paid $30,000 for their stock. As of the beginning of 2010, Texas's Subchapter C NOL carryforward is $110,000. Its taxable income projections for the next few years are as follows.

CRITICAL THINKING

DECISION MAKING

2010	$40,000
2011	25,000
2012	25,000
2013	25,000

Will you counsel Texas to make the S election?

36. **LO.6, 7** C&C Properties is an S corporation and owns two rental real estate undertakings: Carrot Plaza and Cantaloupe Place. Both properties produce an annual $10,000 operating loss. C&C's Schedule K aggregates the results of the two locations into one number.

CRITICAL THINKING

Dan and Marta, C&C's two equal shareholders, both hold a $7,000 stock basis in C&C as of the beginning of the year. Marta actively participates in the Cantaloupe location, but not at Carrot. Dan actively participates at neither location. Determine the amount of the available loss pass-throughs for both shareholders.

COMPREHENSIVE TAX RETURN PROBLEM

TAX RETURN PROBLEM



37. Dana Mitchell (123–45–6781) and Deborah Marshall (123–45–6782) are 70% and 30% owners of Dana, Inc. (11–1111111), a candy company located at 145 Avenue A, Dime Box, TX 77823. The company's S corporation election was made on January 15, 2005. The following information was taken from the income statement for 2009.

Tax-exempt income	$ 10,000
Net rent income	50,000
Interest income	100,000
Gross sales receipts	1,100,000
Beginning inventory	9,607
Direct labor	103,102
Direct materials purchased	178,143
Direct other costs	49,356
Ending inventory	3,467
Salaries and wages	42,103
Officers' salaries	50,000
Repairs	16,106
Depreciation	15,254
Interest expense	5,222
Rent expense (operating)	40,000
Taxes	15,101
Charitable contributions (cash)	20,000
Advertising expenses	30,000
Payroll penalties	15,000
Other deductions	49,899
Net income	624,574

A comparative balance sheet appears below.

	January 1, 2009	December 31, 2009
Cash	$ 47,840	$?
Accounts receivable	93,100	123,104
Inventories	9,607	3,467
Prepaid expenses	8,333	17,582
Building and equipment	138,203	185,348
Accumulated depreciation	(84,235)	?
Land	2,000	2,000
Total assets	$214,848	$764,422
Accounts payable	$ 42,500	$ 72,300
Notes payable (less than 1 year)	4,500	2,100
Notes payable (more than 1 year)	26,700	24,300
Capital stock	30,000	30,000
Retained earnings	111,148	?
Total liabilities and capital	$214,848	$764,422

Dana's accounting firm provides the following additional information.

Distributions to shareholders $100,000

Using the above information, prepare a complete Form 1120S and a Schedule K–1 for Dana Mitchell, 545 Avenue C, Dime Box, TX 77823. If any information is missing, make realistic assumptions and list them.

1. Using an online research service, determine whether your state:
   a. Allows flow-through treatment for Federal S corporations.
   b. Requires any state-specific form to elect or elect out of S treatment at the state level.
   c. Places any additional withholding tax burdens on out-of-state U.S. shareholders or on non-U.S. shareholders of an S corporation.
   d. Requires any additional information disclosures or compliance deadlines for S corporations operating in the state *other than* to the revenue department (e.g., a report that must be filed with the secretary of state).
   e. Accepts "composite" or "block" income tax returns.

Bridge DISCIPLINE

RESEARCH PROBLEMS

Note: Solutions to Research Problems can be prepared by using the **Checkpoint® Student Edition** online research product, which is available to accompany this text. It is also possible to prepare solutions to the Research Problems by using tax research materials found in a standard tax library.

THOMSON REUTERS
Checkpoint® Student Edition

Research Problem 1. Eel Corporation, in Spivey Corners, North Carolina, has filed a Form 1120S for six years, and the local office of the IRS has sent the company a letter requesting an audit next month. Carrie, who is in charge of tax matters at Eel, cannot find a copy of the original S election, Form 2553.

The original shareholders and officers all agree that a local accountant filed the form, but he passed away last year. Several of the shareholders instruct Carrie to prepare a backdated Form 2553, which they will sign. Carrie could then copy the form and tell the agent that this was a copy of the original Form 2553. What should Carrie do? She estimates that any proposed deficiency would be in the range of $625,000.

DECISION MAKING

Partial list of research aids:
§§ 1362(b)(5) and (f).
Rev.Proc. 97–48, 1997–2 C.B. 521.
Ltr.Rul. 9748033.

Research Problem 2. Beecher, Inc., is a calendar year S corporation. Its accountant, Stephanie Brewer, approaches you with this question: May an existing S corporation convert to an LLC and elect to be treated as a corporation without losing its S status? Write an e-mail to Brewer, summarizing your findings.

COMMUNICATIONS

Use the tax resources of the Internet to address the following questions. Do not restrict your search to the Web, but include a review of newsgroups and general reference materials, practitioner sites and resources, primary sources of the tax law, chat rooms and discussion groups, and other opportunities.

INTERNET *activity*

Research Problem 3. Go to the Internet site of a newspaper or business magazine and find a case study of how to start a small business and choose the best tax entity (e.g., C corporation, S corporation, etc.). Summarize your findings in an e-mail to your instructor.

COMMUNICATIONS

Research Problem 4. Use a spreadsheet program to graph the growth in the number of S corporation returns filed. Obtain data for these years: 1975, 1980, 1985, 1990, 1995, 2000, and 2005. In a note to your instructor, explain the trends that you found in S returns filed.

COMMUNICATIONS

Research Problem 5. Which types of trusts can own S corporation stock? Summarize your findings in a PowerPoint presentation (maximum 3 slides) for your classmates.

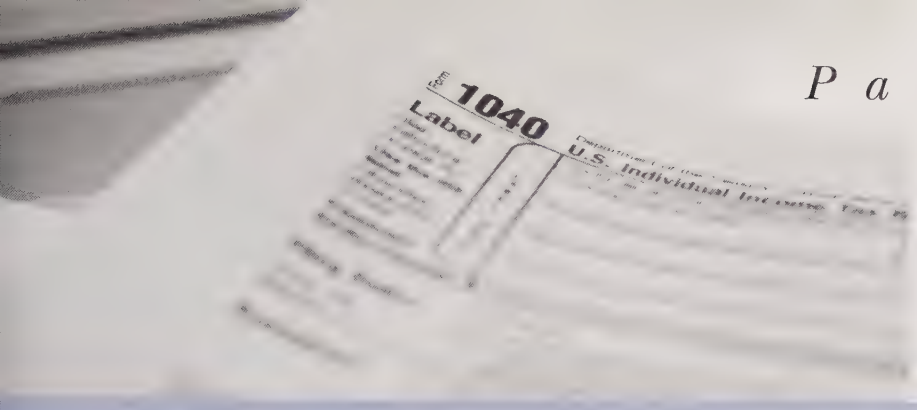
COMMUNICATIONS

Research Problem 6. Print out a copy of the S corporation Schedule M–3. Compare it to the partnership Schedule M–3. On one PowerPoint slide, list the four most important differences between the forms.

COMMUNICATIONS

Research Problem 7. What are the tax consequences if the shareholders engage in a partial liquidation of an S corporation? Summarize your findings in a PowerPoint presentation for your classmates.

COMMUNICATIONS



Part 5

Special Business Topics

CHAPTER 13 Multijurisdictional Taxation

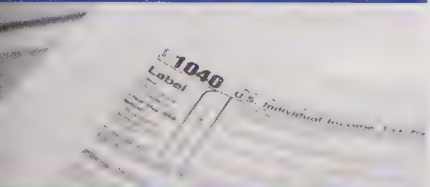
CHAPTER 14 Business Tax Credits and Corporate Alternative Minimum Tax

CHAPTER 15 Comparative Forms of Doing Business

Part 5 covers several topics that are relevant to all types of business entities. Business entities operate in both the international arena and state arenas. Therefore, multijurisdictional taxation is addressed from both a multinational business perspective and a multistate business perspective. A very important component of the basic tax model, tax credits, is presented next. This is followed by a discussion of the alternative tax system applicable to certain C corporations, that is, the AMT. Part 5 concludes with a comparative analysis of the different types of business entities previously discussed. This analysis recognizes the relevance of each of the three life cycle components in selecting a business entity form.

CHAPTER 13

Multijurisdictional Taxation



LEARNING OBJECTIVES

After completing Chapter 13, you should be able to:

LO.1 Recognize the computational and compliance **issues that arise when a taxpayer operates in more than one taxing jurisdiction**. **(pp. 13-2 to 13-4)**

LO.2 Identify the **sources of tax law applicable to a taxpayer operating in more than one country**. **(pp. 13-4 to 13-6)**

LO.3 Outline the U.S. tax effects related to the **offshore operations of a U.S. taxpayer**. **(pp. 13-6 to 13-19)**

LO.4 Describe the tax effects related to the **U.S. operations of a non-U.S. taxpayer**. **(pp. 13-19 to 13-21)**

LO.5 Identify the **sources of tax law applicable to a taxpayer operating in more than one U.S. state**. **(pp. 13-21 to 13-24)**

LO.6 Apply computational principles designed for a taxpayer **operating in more than one U.S. state**. **(pp. 13-24 to 13-29)**

LO.7 **Synthesize the international and multistate tax systems** and recognize common issues faced by both systems. **(pp. 13-29 to 13-35)**

TAX *Talk*

Don't tax you, don't tax me; tax the fellow behind the tree.

—Russell B. Long

Don't tax you, don't tax me; tax the companies across the sea.

—Dan Rostenkowski

OUTLINE

13.1 The Multijurisdictional Taxpayer, 13-2
13.2 U.S. Taxation of Multinational Transactions, 13-3
Sources of Law, 13-4
Tax Issues, 13-6
13.3 Crossing State Lines: State and Local Income Taxation in the United States, 13-21
Sources of Law, 13-21
Tax Issues, 13-23
13.4 Common Challenges, 13-29
Authority to Tax, 13-29
Division of Income, 13-29
Transfer Pricing, 13-30
Tax Havens, 13-34
Interjurisdictional Agreements, 13-34

THE BIG PICTURE Tax Solutions for the Real World

GOING INTERNATIONAL

VoiceCo, a domestic corporation, designs, manufactures, and sells specialty microphones for use in theaters. All of its activities take place in Florida, although it ships products to customers all over the United States. When it receives inquiries about its products from foreign customers, VoiceCo decides to test the foreign market and places ads in foreign trade journals. Soon, it is taking orders from foreign customers.

VoiceCo is concerned about its potential foreign income tax exposure. Although it has no assets or employees in the foreign jurisdictions, it now is involved in international commerce. Is VoiceCo subject to income taxes in foreign countries? Must it pay U.S. income taxes on the profits from its foreign sales? What if VoiceCo pays taxes to other countries? Does it receive any benefit from these payments on its U.S. tax return?

Suppose that VoiceCo establishes a manufacturing plant in Ireland to meet the European demand for its products. VoiceCo incorporates the Irish operation as a controlled foreign corporation (CFC) named VoiceCo-Ireland. So long as VoiceCo-Ireland does not distribute profits to VoiceCo, will the profits escape U.S. taxation? What are the consequences to VoiceCo of being the owner of the CFC? **Read the chapter and formulate your response.**

One of the tax planning principles that has been discussed throughout this text relates to the use of favorable tax jurisdictions—moving income into lower-taxed districts and deductions into higher-taxed ones. Many individuals dream of moving all of their income and wealth to a tax-friendly state or a proverbial island in the tropics, never to be taxed again. This chapter examines the temptations that attract taxpayers to this idea and various ways in which this goal can and cannot be accomplished.

13.1 The Multijurisdictional Taxpayer

LO.1

Recognize the computational and compliance issues that arise when a taxpayer operates in more than one taxing jurisdiction.

Companies large and small must deal with the consequences of earning income through activities in different jurisdictions. A small business may have its center of operations in a single city but have customers in many states and countries. Consider the typical U.S. multinational corporation. Its assets, employees, customers, suppliers, lenders, and owners are located in numerous locations, crossing city, county, state, national, and even "virtual" borders.

Bridge DISCIPLINE

Bridge to International Law

Many of the provisions of the U.S. tax law relating to international transactions are thinly disguised extensions of a principle of international law—the ability of sovereign countries to protect the safety and privacy of their citizens abroad.

For instance, U.S. tax auditors often have difficulty obtaining or reviewing the documentation supporting deductions claimed by U.S. taxpayers operating overseas. Banking, credit card, and other records that are available (in the course of business or forcibly by summons) for strictly U.S. transactions are not available once those same transactions cross national borders.

How could the U.S. tax base include rental and royalty income of a U.S. investor operating through a corporation in another country when property ownership and taxation records are not available for substantiation or audit outside the country of the investment? Perhaps this explains why the U.S. tax base typically excludes such items.

Conversely, when the taxing agencies of multiple countries are allowed by law to trade among themselves information about business operations and taxpayers, the fairness and completeness of the taxing process may improve. But such lengthening of the reach of the taxing authorities results from diplomatic negotiations among the countries, not from the passage of legislation.

EXAMPLE 1

RobotCo, a corporation created and organized in Delaware, produces and sells robotic manufacturing equipment. It holds its valuable patents and intangible property in Delaware and Bermuda. The company has manufacturing operations in Ireland, Singapore, Germany, Texas, and New Jersey. It has distribution centers in Canada, the United Kingdom, Germany, Hong Kong, Texas, New Jersey, Georgia, California, Illinois, and Arizona. RobotCo's sales force spends time in Europe, Asia, Mexico, Canada, and almost every state in the union. RobotCo's engineers likewise provide technical service to customers wherever they may be located. And in recent years, RobotCo has developed a substantial Web presence.

RobotCo must determine its potential exposure to tax in each of these jurisdictions. Such exposure usually is based on RobotCo's nexus (or economic connection) to the various locations. Unfortunately for all concerned, each of these taxing jurisdictions uses a different taxing system and methods, imposes taxes under differing structures, and even defines the tax base differently. How does RobotCo divide its income among the various jurisdictions that want a piece of the tax pie, determine its tax costs, mitigate any potential double taxation, and file the appropriate information returns with this diverse set of taxing authorities? Such questions and more must be addressed by modern-day businesses. ■

Thousands of state and local jurisdictions are involved in the taxation of interstate transactions through income, property, sales, or other taxes. State and local taxes make up over one-third of all taxes collected in the United States. Global trade also represents a major portion of the U.S. economy. In 2008, U.S. exports of goods and services amounted to $1.8 trillion, with imports reaching $2.5 trillion. As of the beginning of 2009, U.S. companies had direct investments abroad exceeding $3 trillion, and foreign companies had invested over $2 trillion in U.S. businesses. Hundreds of countries and many more political subdivisions participated in the taxation of these transactions. These interstate and international trade flows, along with cross-state and cross-country investments, create significant Federal, state, and local tax consequences for both U.S. and foreign entities.

13.2 U.S. Taxation of Multinational Transactions

Cross-country transactions create the need for special tax considerations for both the United States and its trading partners. From a U.S. perspective, international tax laws should promote the global competitiveness of U.S. enterprises and at the same

FIGURE 13.1 U.S. Taxation of International Transactions

	U.S. Person	Foreign Person
U.S.-Source Income	Domestic taxation only	"Inbound" taxation
Foreign-Source Income	"Outbound" taxation	Limited U.S. authority to tax

time protect the tax revenue base of the United States. These two objectives sometimes conflict, however. The need to deal with both objectives contributes to the complexity of the rules governing the U.S. taxation of cross-border transactions.

EXAMPLE 2

U.S. persons engage in activities outside the United States for many different reasons. Consider two U.S. corporations that have established sales subsidiaries in foreign countries. Dedalus, Inc., operates in Germany, a high-tax country, because customers demand local attention from sales agents. Mulligan, Inc., operates in the Cayman Islands, a tax haven country, simply to shift income outside the United States. U.S. tax law must fairly address both situations with the same law. ■

U.S. international tax provisions are concerned primarily with two types of potential taxpayers: U.S. persons earning income from outside the United States and non-U.S. persons earning income from inside the United States.[1] U.S. persons earning income only from inside the United States do not create any international tax issues and are taxed under the purely domestic provisions of the Internal Revenue Code. Foreign persons earning income from outside the United States are not within the taxing jurisdiction of the United States (unless this income is somehow directly connected to U.S. operations).

The U.S. taxation of international transactions can be organized in terms of "outbound" and "inbound" taxation. **Outbound taxation** refers to the U.S. taxation of foreign-source income earned by U.S. taxpayers. **Inbound taxation** refers to the U.S. taxation of U.S.-source income earned by foreign taxpayers. Figure 13.1 summarizes these concepts.

LO.2

Identify the sources of tax law applicable to a taxpayer operating in more than one country.

SOURCES OF LAW

U.S. individuals and companies operating across national borders are subject to both U.S. law and the laws of the other jurisdictions in which they operate or invest. Accordingly, the source of law depends on the nature of a taxpayer's connection with a particular country. For U.S. persons, the Internal Revenue Code addresses the tax consequences of earning income anywhere in the world. However, U.S. persons also must comply with the local tax law of the other nations in which they operate. For non-U.S. persons, U.S. statutory law is relevant to income they earn that is connected to U.S. income-producing activities, whether those activities involve a passive investment or an active trade or business. Whether non-U.S. persons are also subject to potential tax in their home countries on their U.S. income depends on their own local tax law.

It is difficult for the United States (or any country) to craft local tax laws that equitably address all of the potential issues that arise when two countries attempt to tax the same income. Furthermore, any uncertainty as to tax consequences can be an impediment to global business investment. Consequently, countries enter into **income tax treaties** with each other to provide more certainty to taxpayers.

Tax treaties are the result of specific negotiations with each treaty partner, so each treaty is unique. Nevertheless, all tax treaties are organized in the same way and

[1]The term "person" includes an individual, corporation, partnership, trust, estate, or association. § 7701(a)(1). The terms "domestic" and "foreign" are defined in §§ 7701(a)(4) and (5).

TAX

U.S. Income Tax Treaties in Force

The United States has entered into income tax treaties with the following nations:

Australia	Finland	Korea	Russia
Austria	France	Latvia	Slovak Republic
Barbados	Germany	Lithuania	Slovenia
Belgium	Greece	Luxembourg	South Africa
Canada	Hungary	Mexico	Spain
China	Iceland	Morocco	Sweden
Commonwealth of Independent States*	India	Netherlands	Switzerland
	Indonesia	New Zealand	Thailand
	Ireland	Norway	Trinidad and Tobago
Cyprus	Israel	Pakistan	Tunisia
Czech Republic	Italy	Philippines	Turkey
Denmark	Jamaica	Poland	United Kingdom
Egypt	Japan	Portugal	Venezuela
Estonia	Kazakhstan	Romania	

*The income tax treaty between the United States and the former Soviet Union applies to the countries of Armenia, Azerbaijan, Belarus, Georgia, Kyrgyzstan, Moldova, Tajikistan, Turkmenistan, Ukraine, and Uzbekistan. The Commonwealth of Independent States is an association of many of the former constituent republics of the Soviet Union.

address similar issues. For example, all treaties include provisions regarding the taxation of investment income, business profits from a **permanent establishment (PE)**, personal service income, and exceptions for certain persons (e.g., athletes, entertainers, students, and teachers). Treaty provisions generally override the treatment otherwise called for under the Internal Revenue Code or foreign tax statutes.

Permanent establishment (PE) is an important concept that is defined in all income tax treaties. A person has a PE within a country when its activities within that country rise beyond a minimal level. Tax treaties outline the activities that create a PE, including an office, plant, or other fixed place of business. Treaties also specify specific activities that do not create a PE (e.g., maintaining goods in a warehouse or a temporary construction project). Once a person has a PE within a country, the business profits associated with the PE become subject to tax in that country.

EXAMPLE 5

Amelia, Inc., a U.S. corporation, sells boating supplies to customers in the United States and Canada. Amelia has no assets in Canada. All Canadian sales transactions are conducted via the Internet or telephone from Amelia's Florida office. Because Amelia does not have any assets in Canada or conduct any activities within Canada, it does not have a Canadian PE. Consequently, Canada does not impose an income tax on the profit associated with Amelia's Canadian sales. However, if Amelia opens a sales office in Canada, a PE will exist, and Canada will tax the profits associated with the PE. ■

Although the United States has entered into more than 50 income tax treaties, many jurisdictions where U.S. taxpayers operate are not covered by a treaty. Where there is no tax treaty, the more subjective test of whether a person is "engaged in a trade or business" within a country replaces the PE determination. Both the PE concept and the engaged in a trade or business concept are closely related to the determination of whether a person has nexus within a jurisdiction for state and local tax purposes (discussed later in this chapter).

Tax Planning Strategies TREATY SHOPPING

FRAMEWORK FOCUS: TAX RATE

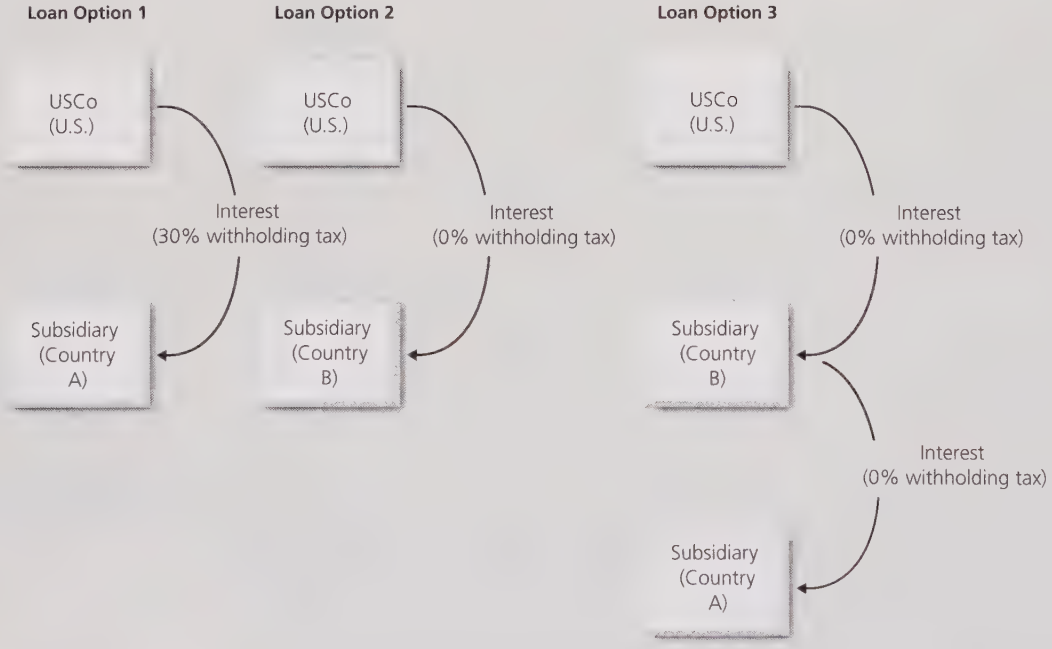
Strategy: Avoid Double Taxation.

U.S. taxpayers with operations in countries that do not have a treaty with the United States may attempt to arrange their activities to take advantage of other countries' tax treaties. In some cases, structuring a company's global operations in this way is simply good tax planning. In other cases, attempts to benefit from tax treaties constitute unwarranted treaty shopping.

USCo, a domestic corporation, owns subsidiaries in Country A and Country B. The U.S. parent wants to obtain a loan from its A subsidiary. The United States does not have a tax treaty with A, but it does have a tax treaty with B. Countries A and B have a tax treaty with each other. The home tax laws of all three countries impose a withholding tax on payments of interest to persons outside the country. However, the existing tax treaties exempt interest payments from withholding.

If the U.S. parent borrows money directly from its A subsidiary, any interest paid to the subsidiary is subject to a 30 percent withholding tax under the Internal Revenue Code (loan option 1). If the U.S. parent instead borrows money from its B subsidiary, any interest paid to the subsidiary is not subject to withholding under the treaty (loan option 2). Thus, USCo's choice of obtaining the loan from its A subsidiary or its B subsidiary possesses major tax consequences. Making such decisions is part of an appropriate global tax plan.

Alternatively, the U.S. parent could use the B subsidiary as a mere conduit by funneling A funds to B via a loan and then having the B subsidiary lend these funds to the U.S. parent (loan option 3). In this case, however, the ability of the U.S. parent to benefit from the tax treaty with B may be restricted by the provisions of the treaty itself or by U.S. tax law. The United States is likely to take an anti-treaty-shopping position. In such case, it would ignore the intermediate payment to the B subsidiary and treat the interest as being paid directly to the A subsidiary, resulting in a 30 percent withholding tax.



LO.3

Outline the U.S. tax effects related to the offshore operations of a U.S. taxpayer.

TAX ISSUES

Authority to Tax

The United States taxes the worldwide income of U.S. taxpayers.[2] The United States claims the right to tax all of a U.S. person's income because of the protection of U.S. law provided to a person connected to the United States through citizenship, residency, or place of organization.

[2]Gross income for a U.S. person includes all income from whatever source derived. "Source" in this context means not only type of income (e.g., wages or interest) but geographic source as well (e.g., the United States or Belgium). § 61.

TAX FACT

WHERE DO WE STAND?

The drastic reductions in marginal tax rates brought about in the United States in 1981 and 1986, and the ongoing effort by Congress to make the Federal corporate income tax neutral as to the business decisions of U.S. entities operating in the global economy, have rippled through the rest of the world. Even perpetually high-tax countries like Sweden and the United Kingdom were forced to cut back marginal tax rate structures to remain competitive and often also had to change the tax base to match the revisions of the U.S. tax law.

As a result of this dramatic evolution in international tax rates, the average marginal business income tax rate in developed countries now lies between 30 and 35 percent, down from perhaps 50 percent in the 1960s. This description does not take into account, though, the dependence of many U.S. trading partners on transaction taxes, like the value added tax and wealth-based taxes, which make difficult an apples-to-apples comparison of rates alone. Further, each country treats payroll taxes and entitlements differently, and these are increasingly expensive components of the tax structure. After taking these other taxes into account, the United States may be closer to the worldwide average.

But U.S. corporate income tax law has not changed much since the 1980s, and the rest of the world appears to be continuing the rate-cutting that the United States started. The United States may need another round of rate cuts to stay in the game. By one measure, at least, the United States now is the second-highest-taxing country in the developed world.

Country	Corporate Income Tax, Average Rate, State and Federal (%)
Japan	39.5
United States	39.25
France	34.4
Germany	30.2
United Kingdom	28.0
Sweden	28.0
Switzerland	21.2
Ireland	12.5
OECD Average	26.6

Because non-U.S. governments may also tax some of the U.S. person's income when it is earned within their borders, U.S. taxpayers may be subjected to double taxation. There are two broad methods of mitigating this double taxation problem. Under the territorial approach, a country simply exempts from tax the income derived from sources outside its borders. Some European and Asian countries have adopted this approach.[3] The second approach, and the one adopted by the United States, is to provide a **foreign tax credit** (FTC) against home country taxes for taxes paid to other countries on the same income. The United States allows its taxpayers to reduce their U.S. tax liability by some or all of the foreign income taxes paid on income earned outside the United States.

EXAMPLE 1

Gator Enterprises, Inc., a U.S. corporation, operates a manufacturing branch in Italy because of customer demand in Italy, local availability of raw materials, and the high cost of shipping finished goods. This branch income is taxed in the United States as part

[3]In some cases, countries allow the territorial exemption from home country taxation only if the income has been subject to tax in another country. Other countries, however, exempt such income even if no source country tax is imposed.

TAX in the NEWS

Last Chance to Come Clean on Foreign Bank Accounts

U.S. persons may have attempted to evade U.S. income taxes on foreign income through the use of undisclosed foreign bank accounts. On March 26, 2009, IRS Commissioner Doug Shulman released a statement on offshore income outlining an opportunity for these noncompliant taxpayers to come forward and voluntarily disclose their foreign bank accounts, so as to settle their tax bills.

The IRS provided an example of a U.S. person with $1 million in a foreign bank account and $50,000 per year in unreported interest for six years. The taxpayer would pay $386,000 in taxes and penalties (plus interest) if he or she participated in the voluntary disclosure program. However, without voluntary disclosure, once the undisclosed income was discovered, the taxpayer would pay $2,306,000 in taxes and penalties (plus interest) and face the possibility of other penalties and criminal prosecution. The deadline for this disclosure was October 15, 2009, and about 15,000 U.S. taxpayers participated in the program by making disclosures.

Source: *Voluntary Disclosure,* **www.irs.gov/newsroom/article/0,,id=206012,00.html.**

of Gator's worldwide income, but it is also taxed in Italy. Without the availability of a foreign tax credit to mitigate this double taxation, Gator Enterprises would suffer an excessive tax burden and could not compete with local Italian companies. ■

The United States does adopt the territorial approach in taxing foreign persons. Such "inbound" taxpayers generally are subject to tax only on income earned within U.S. borders.

EXAMPLE 5

Purdie, Ltd., a corporation based in the United Kingdom, operates in the United States. Although not a U.S. person, Purdie is taxed in the United States on its U.S.-source business income. If Purdie, Ltd., could operate free of U.S. tax, its U.S.-based competitors would face a serious disadvantage. ■

Income Sourcing

Determining the source of net income is a critical component in calculating the U.S. tax consequences to both U.S. and foreign persons. A number of specific provisions contained in §§ 861 through 865 address the income-sourcing rules for all types of income, including interest, dividends, rents, royalties, services, and sales of assets. Although sometimes complex and subject to various special exceptions, these sourcing rules generally assign income to a geographic source based on the location where the economic activity producing the income took place. In some cases, this relationship is clear, and in others the connection is more obscure.

EXAMPLE 6

Wickless, Inc., a U.S. corporation, provides scuba diving lessons to customers in Florida and in the Bahamas. These services are sourced based on the place where the activity is performed. The services performed in Florida are U.S.-source income, and those performed in the Bahamas are foreign-source income. Because Wickless, Inc., is a U.S. person, all the income, U.S. and foreign, is subject to U.S. taxation. But the foreign-source portion is important in determining any available foreign tax credits for Wickless. ■

EXAMPLE 7

Brown, Inc., a U.S. corporation, receives dividend income from Takeda Corporation, a Japanese corporation, based on its ownership of Takeda common stock. Brown purchased the stock in the United States and receives all payments in the United States. At first glance, it appears that all of the activities related to earning the dividend income take place in the United States. Nevertheless, the dividend income is treated as foreign source because it is paid by a foreign corporation.[4] ■

[4]Section 861(a)(2) establishes that only dividends from domestic corporations are U.S.-source income.

Tax Planning Strategies DEFERRAL AND REPATRIATION

FRAMEWORK FOCUS: TAX RATE

Strategy: Shift Net Income from High-Tax Jurisdictions to Low-Tax Jurisdictions.

FRAMEWORK FOCUS: INCOME

Strategy: Postpone Recognition of Income to Achieve Tax Deferral.

U.S. taxpayers with foreign operations have a choice as to how they structure such operations for U.S. tax purposes. If the U.S. taxpayer operates through an unincorporated foreign branch, the net profits from the foreign branch are subject to current taxation in the U.S. tax return of the U.S. taxpayer. If instead the U.S. taxpayer operates abroad through a separate wholly owned foreign corporation, the income from the foreign operation is deferred from U.S. taxation until the profits are repatriated back to the United States (via a dividend or similar distribution), or when they are treated as repatriated through the operation of the Subpart F deemed dividend provisions (as discussed later). This option can have a significant effect on a U.S. taxpayer's current-period tax burden, particularly if the foreign operations are in a lower-tax jurisdiction.

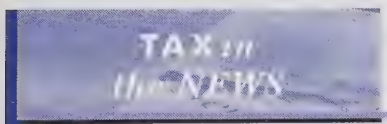
LeshCo, Inc., a domestic corporation, wishes to establish a manufacturing operation in Ireland. The Irish operations are expected to produce 2 million euros in net profits each year, and the income tax rate in Ireland is 12.5 percent. Consider the difference between operating in Ireland as a branch versus an Irish corporate subsidiary. If LeshCo operates as an unincorporated branch, it directly pays 250,000 euros in Irish taxes (2 million × 12.5%). Assuming $1 equals 1 euro for simplicity, this has the following effect on LeshCo's U.S. tax liability for the current year.

Irish branch profits	$2,000,000
U.S. tax at 35% (before FTC)	$ 700,000
FTC allowed	(250,000)
Residual U.S. tax	$ 450,000

With a branch operation, LeshCo pays a total tax of $700,000 on its $2 million of foreign income ($250,000 in Irish taxes and $450,000 in U.S. taxes).

If instead LeshCo operates in Ireland through a wholly owned Irish subsidiary and does not repatriate its profits back to the United States, LeshCo pays only the $250,000 in Irish taxes at this time. The potential $450,000 in U.S. taxes is deferred until LeshCo later repatriates its Irish profits. As discussed in Chapter 3, under ASC 740 (APB 23) this deferral of taxes also can reduce the financial statement tax expense if the Irish profits are indefinitely reinvested outside the United States.

In addition to sourcing income, the U.S. rules require taxpayers to assign deductions to U.S.- or foreign-source categories. Deductions that are directly related to an activity or property are first allocated to classes of income to which they directly relate. This is followed by an apportionment between the U.S. and foreign groupings using some reasonable basis (e.g., revenue, gross profit, assets, units sold, time spent). If a deduction is not definitely related to any class of gross income, the deduction is first assigned to all classes of gross income and then apportioned between U.S.- and foreign-source income.



SOURCING INCOME IN CYBERSPACE

The use of the Internet in consumer and business transactions is posing problems for the taxing authorities. Consumers purchase books, music, clothing, and food from Internet retailers. Businesses negotiate with suppliers via online auctions of products and services. Consultants provide services to their clients over the Web. Almost all transactions have a counterpart that takes place in cyberspace. The existing income-sourcing rules were developed long before the existence of the Internet, and taxing authorities are finding it challenging to apply these rules to Internet transactions.

Where does a sale take place when the web server is in the Cayman Islands, the seller is in Singapore, and the customer is in Texas? Where is a service performed when all activities take place over the Web? These questions and more must be answered by the United States and its trading partners as the Internet economy grows in size and importance.

EXAMPLE 9

Ace, Inc., a domestic corporation, has $2 million of gross income and a $50,000 expense, all related to real estate sales and rental activities. The expense is allocated and apportioned using gross income as a basis.

	Gross Income			Apportionment	
	Foreign	U.S.	Allocation	Foreign	U.S.
Sales	$1,000,000	$500,000	$37,500*	$25,000	$12,500**
Rentals	400,000	100,000	12,500	10,000	2,500***
			$50,000	$35,000	$15,000

*$50,000 × ($1,500,000/$2,000,000).
**$37,500 × ($500,000/$1,500,000).
***$12,500 × ($100,000/$500,000).

If Ace could show that $45,000 of the expense was directly related to sales income, the $45,000 would be allocated directly to that class of gross income, with the remainder allocated and apportioned between U.S. and foreign source ratably based on gross income. ■

Many deductions may be allocated and apportioned based on any reasonable method the taxpayer chooses.[5] However, the U.S. tax rules impose a specific method for certain types of deductions, including interest and research and experimentation expenses. Interest expense is allocated and apportioned based on the theory that money is fungible. For example, if a taxpayer borrows to support its manufacturing activity, this frees up other funds for use to support its investment activities. Accordingly, the tax rules require that interest expense be allocated and apportioned to all the activities and property of the taxpayer, regardless of the specific purpose for incurring the debt on which interest is paid. Taxpayers must allocate and apportion interest expense on the basis of asset location, using either the fair market value or the tax book value of the assets.

EXAMPLE 10

Fisher, Inc., a domestic corporation, generates both U.S.-source and foreign-source gross income for the current year. Fisher's assets (tax book value) are as follows.

Assets generating U.S.-source income	$18,000,000
Assets generating foreign-source income	5,000,000
	$23,000,000

Fisher incurs interest expense of $800,000 for the current year. Using the tax book value method, interest expense is apportioned to foreign-source income as follows.

$$\frac{\$5,000,000\text{ (foreign assets)}}{\$23,000,000\text{ (total assets)}} \times \$800,000\text{ (interest expense)} = \$173,913.$$ ■

Tax Planning Strategies — Sourcing Income from Sales of Inventory

FRAMEWORK FOCUS: TAX RATE

Strategy: Control the Character of Income and Deductions.

Generally, income from the sale of personal property is sourced according to the residence of the seller under § 865. Several important exceptions exist for inventory. Income from the sale of purchased inventory is sourced in the country in which the sale takes place under the "title passage" rule. This rule provides the taxpayer with flexibility with regard to sourcing and allows for the creation of zero-taxed foreign-source income.

USCo, a domestic corporation, purchases inventory for resale from unrelated parties and sells the inventory to customers in the United States and Brazil. If title on the Brazilian sales passes in the United States (i.e., risks of loss shift to

[5]Reg. § 1.861–8.

the Brazilian customers at the shipping point), the inventory income is U.S. source. If title passes outside the United States (e.g., at the customer's warehouse in Brazil), the inventory income is foreign source. Although the Code identifies the income item as foreign source, this income likely is not subject to any Brazilian tax because USCo has no employees, assets, or activities in Brazil. Although the income is subject to U.S. tax in either case (as it represents taxable income to USCo), in the latter case USCo has generated foreign-source income with no corresponding foreign income tax. This will prove very useful in managing USCo's ability to use foreign tax credits, as discussed later in this chapter.

When a taxpayer both produces and sells inventory, the income is apportioned between the country of production and the country of sale. Taxpayers often use a 50–50 allocation method as allowed by § 863(b), where 50 percent of the profits from the sale are automatically assigned to the location of the production assets, and 50 percent of the profits are assigned to the location where title passes.

Assume that USCo manufactures inventory in its Texas plant and sells the inventory to customers in Mexico. Regardless of the actual economic profit relationship between the manufacturing and selling activities, 50 percent of the profit on the Mexican sales can be assigned to foreign-source income by simply passing title outside the United States.

The Foreign Tax Credit

As discussed earlier, the United States retains the right to tax its citizens and residents on their worldwide taxable income. This approach can result in double taxation, presenting a potential problem to U.S. persons who operate abroad. To reduce the possibility of double taxation, Congress created the foreign tax credit (FTC). A qualified taxpayer is allowed a tax credit for foreign income taxes paid or accrued. The credit is a dollar-for-dollar reduction of U.S. income tax liability.

EXAMPLE 10

Caulkin Tools, Inc., a U.S. corporation, has a branch operation in Mexico from which it earns taxable income of $750,000 for the current year. Caulkin pays income tax of $150,000 on these earnings to the Mexican tax authorities. Caulkin must also include the $750,000 in gross income for U.S. tax purposes. Before considering the FTC, Caulkin owes $255,000 in U.S. income taxes on this foreign-source income. Thus, total taxes on the $750,000 could equal $405,000 ($150,000 + $255,000), a 54% effective rate. But Caulkin takes an FTC of $150,000 against its U.S. tax liability on the foreign-source income. Caulkin's total taxes on the $750,000 now are $255,000 ($150,000 + $105,000), a 34% effective rate. ■

EXAMPLE 11

MettCo, Inc., a domestic corporation, receives a $5,000 dividend from DeanCo, Ltd., a foreign corporation owned less than 5% by MettCo. The foreign country imposes a 20% withholding tax on dividend payments to nonresidents. Accordingly, DeanCo withholds $1,000 ($5,000 × 20%) from the dividend and remits this tax to the local country tax authorities. DeanCo pays the remaining $4,000 to MettCo.

Although MettCo did not directly pay the $1,000 in foreign tax, the entire amount is allowed as a direct tax to MettCo for FTC purposes. MettCo reports $5,000 in dividend income on its U.S. tax return (the gross amount of the dividend), but it receives an FTC against any U.S. tax for the $1,000 in foreign withholding tax. ■

The FTC is elective for any particular tax year. If the taxpayer does not "choose" to take the FTC, § 164 allows a deduction for foreign taxes paid or incurred. A taxpayer cannot take a credit and a deduction for the same foreign income taxes, and in most situations the FTC is more valuable to the taxpayer.

U.S. taxpayers may claim FTCs for foreign taxes they pay directly or through withholding as so-called direct credits. In addition, U.S. corporate taxpayers may claim FTCs for foreign taxes paid indirectly. If a U.S. corporation operates in a foreign country through a branch, the direct credit is available for foreign taxes paid. If, however, a U.S. corporation operates in a country through a foreign subsidiary, the direct credit is not available for foreign taxes paid by the foreign corporation. An indirect or **deemed-paid credit** is available to U.S. corporate taxpayers that receive



Corporate Use of the Foreign Tax Credit

Information from 2005 Forms 1120 indicates that the foreign tax credit is used by a small number of corporate taxpayers, but that the credit spans a very large portion of the global economy.

Of foreign tax payments reported on Forms 1118 and 1120, almost 40 percent were paid to European countries, the most going to the United Kingdom, the Netherlands, and Ireland. Tax payments to Canada accounted for 9.4 percent of the total. South Korea received less than 1 percent of total foreign tax payments, and all of Africa totaled only about 5 percent.

Tax returns claiming a foreign tax credit	5,837
Total assets of corporations claiming the credit	$31.2 trillion
Taxable income of corporations claiming the credit	$793 billion
U.S. income tax liability of corporations claiming the credit	$278.2 billion
Foreign tax credit claimed	$84 billion
Foreign income taxes available for the credit	$111.6 billion

actual or constructive dividends from foreign corporations that have paid foreign income taxes.[6] These foreign taxes are deemed paid by the corporate shareholders in the same proportion as the dividends actually or constructively received bear to the foreign corporation's post-1986 undistributed E & P.

$$\text{Deemed-paid credit} = \frac{\text{Actual or constructive dividend}}{\text{Post-1986 undistributed E \& P}} \times \text{Post-1986 foreign taxes}$$

If a U.S. taxpayer claims a deemed-paid credit, § 78 requires the corporation to *gross up* (add to income) the dividend income by the amount of the deemed-paid credit.

EXAMPLE 31

Wren, Inc., a domestic corporation, owns 50% of Finch, Inc., a foreign corporation. Wren receives a dividend of $120,000 from Finch. Finch paid foreign taxes of $500,000 on post-1986 E & P, which totals $1.2 million. Wren's deemed-paid foreign taxes for FTC purposes are $50,000.

Cash dividend from Finch	$120,000
Deemed-paid foreign taxes [($120,000/$1,200,000) × $500,000]	50,000
Gross income to Wren	$170,000

Wren includes $170,000 in gross income for the year. As a result of the dividend received, Wren can claim a credit for the $50,000 in deemed-paid foreign taxes. ■

The United States does not automatically grant an FTC for all foreign taxes paid, and there are limits on the amount of foreign taxes that can be taken as a credit. First, only foreign *income* taxes are potentially creditable. Second, the FTC allowed in any tax year is limited to the U.S. tax imposed on the foreign-source income included on the U.S. tax return.[7] Thus, taxpayers are allowed a credit for the lesser of the foreign income taxes paid or accrued, or the following limitation.

$$\text{FTC limit} = \frac{\text{Foreign-source taxable income}}{\text{Worldwide taxable income}} \times \text{U.S. tax liability before FTC}$$

[6] U.S. corporations must meet certain minimum ownership requirements under § 902 to claim a deemed-paid credit.

[7] Sections 901, 902, and 903 provide definitions of creditable foreign taxes. Section 904 contains the FTC limitation rules.

Worldwide taxable income is the total taxable income reported on the taxpayer's U.S. tax return, not the total worldwide income of a group of related domestic and foreign entities. Any potential FTCs disallowed because of the FTC limitation may be carried back one year or forward 10 years, subject to the FTC limits in those tax years.

EXAMPLE 13

Lassaline, Inc., a domestic corporation, invests in the bonds of non-U.S. corporations. Lassaline's worldwide taxable income for the tax year is $1.2 million, consisting of $1 million of profits from U.S. sales and $200,000 of interest income from foreign sources. Foreign taxes of $90,000 were withheld on these interest payments. Lassaline's U.S. tax before the FTC is $408,000. Its FTC is limited to $68,000 [($200,000/$1,200,000) × $408,000]. Thus, Lassaline's net U.S. tax liability is $340,000 after allowing the $68,000 FTC. The remaining $22,000 of FTCs ($90,000 − $68,000) may be carried back or forward. ■

Tax Planning Strategies Utilizing the Foreign Tax Credit

FRAMEWORK FOCUS: TAX CREDITS

Strategy: Maximize Tax Credits.

The FTC limitation can prevent the total amount of foreign taxes paid in high-tax jurisdictions from being credited. Taxpayers can overcome this problem by generating additional foreign-source income that is subject to no, or low, foreign taxation. A U.S. taxpayer's ability to use FTCs is directly related to its level of foreign-source income relative to its total taxable income. To the extent that a U.S. taxpayer can keep the average tax rate on its foreign-source income at or below the U.S. tax rate on such income, the foreign taxes will be fully creditable. Consequently, combining high- and low-tax foreign-source income is an important planning objective.

Compare the two situations at the right where a U.S. corporation's FTC situations differ depending on its ability to mix high- and low-taxed income. In the first scenario, the corporation has only $500,000 of highly taxed foreign-source income. In the second scenario, the corporation also has $100,000 of low-taxed foreign-source passive income.

	Only Highly Taxed Income	With Low-Taxed Passive Income
Foreign-source income	$500,000	$600,000
Foreign taxes	275,000	280,000
U.S.-source income	700,000	700,000
U.S. taxes (34%)	408,000	442,000
FTC limitation	170,000*	204,000**

*($500,000/$1,200,000) × $408,000.
**($600,000/$1,300,000) × $442,000.

The corporation's actual foreign taxes increase by only $5,000 ($280,000 versus $275,000), but its FTC limitation increases by $34,000 (from $170,000 to $204,000). The ability to "cross-credit" high- and low-taxed foreign income is available, though, only when the foreign-source income is all classified within the same income basket.

To limit the ability of U.S. taxpayers to cross-credit foreign taxes, the FTC rules provide for two **separate foreign tax credit limitation categories** (or baskets): passive and general. In any tax year, taxpayers are allowed to credit the lesser of foreign income taxes paid or accrued or the FTC limit *within each separate basket.* The separate FTC limitation categories for different types of income each use this same basic FTC limitation formula. The separate limitation categories affect the amount of FTC that can be taken by generally segregating income subject to a high level of foreign tax from lower-taxed foreign income.

EXAMPLE 14

RoyCo, Inc., a domestic corporation, invests in the bonds of non-U.S. corporations. RoyCo's worldwide taxable income for the tax year is $1,200,000, consisting of $1,000,000 of profits from U.S. sales and $200,000 of interest income from foreign sources. All of the foreign income is in the passive basket. Foreign taxes of $90,000 were withheld by tax authorities on these interest payments. RoyCo's U.S. tax before the FTC is $420,000 ($1,200,000 × 35%). Its FTC is limited to $70,000 [$420,000 × ($200,000/$1,200,000)]. Thus,

RoyCo's net U.S. tax liability on this income is $350,000 after allowing the $70,000 FTC. The remaining $20,000 ($90,000 foreign tax paid − $70,000 FTC benefit) of foreign taxes may be carried back one year or forward 10 years, for use within the passive basket. ■

EXAMPLE 31

BenCo, Inc., a U.S. corporation, has a foreign branch in Germany that earns taxable income of $1.5 million from manufacturing operations and $600,000 from passive activities. BenCo pays foreign taxes of $600,000 (40%) and $100,000 ($16^2/_3$%), respectively, on this foreign-source income. The corporation also earns $4 million of U.S.-source taxable income, resulting in worldwide taxable income of $6.1 million. BenCo's U.S. taxes before the FTC are $2,074,000 (at 34%). The following table illustrates the effect of the separate limitation baskets on cross-crediting.

Separate Foreign Income Category	Net Taxable Amount	Foreign Taxes	U.S. Tax before FTC at 34%	FTC Allowed with Separate Limits
General	$1,500,000	$600,000	$510,000	$510,000
Passive	600,000	100,000	204,000	100,000
Total	$2,100,000	$700,000	$714,000	$610,000

Without the separate limitation provisions, the FTC would be the lesser of (1) $700,000 foreign taxes or (2) $714,000 share of U.S. tax [($2,100,000/$6,100,000) × $2,074,000]. The separate limitation provisions reduce the FTC by $90,000 ($700,000 versus $610,000). The effect of the separate limitation rules is that the foreign-source income taxed at the foreign tax rate of 40% cannot be aggregated with foreign-source income taxed at only $16^2/_3$%. ■

DIGGING DEEPER 1

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

Controlled Foreign Corporations

Foreign corporations—even those controlled by U.S. shareholders—generally are not included in a U.S. consolidated income tax return. Consequently, in the absence of some other provision, the income of a foreign corporation is included on the U.S. shareholder's U.S. income tax return only when dividend income is received. To minimize current U.S. tax liability, taxpayers often attempt to defer the recognition of taxable income. One way to do this is to shift the income-generating activity to a foreign entity where the income earned will not be subject to U.S. tax until repatriated.

For example, a U.S. person can create a foreign holding company to own the stock of foreign operating affiliates or intangible assets, such as patents and trademarks. Thus, the income generated by these foreign holdings would escape current U.S. taxation. A non-U.S. corporation can also be used to accumulate income from sales or service activities by acting as an intermediary between the U.S. corporation and an offshore customer. The foreign subsidiary corporation would be used to purchase goods from the U.S. parent or domestic affiliates and then resell the goods to foreign customers or provide services on behalf of the U.S. parent or affiliates.

In some cases, the use of intermediate foreign subsidiaries is based on a substantive business purpose. In other cases, they are employed only to reduce tax costs. Because of this potential for abuse, Congress has enacted various provisions to limit the availability of deferral.

The most important of these antideferral provisions are those affecting **controlled foreign corporations (CFCs)**. Subpart F, §§ 951–964 of the Code, provides that certain types of "tainted" income generated by CFCs are currently included in gross income by the U.S. shareholders without regard to actual distributions. U.S. shareholders must include in gross income their pro rata share of **Subpart F income**. This rule applies to U.S. shareholders who own stock in the corporation on the last day of the tax year or on the last day the foreign corporation is a CFC.

EXAMPLE 16

Jordan, Ltd., a calendar year foreign corporation, is a CFC for the entire tax year. Taylor, Inc., a U.S. corporation, owns 60% of Jordan's one class of stock for the entire year. Jordan earned $100,000 of Subpart F income for the year and makes no actual distributions during the year. Taylor, a calendar year taxpayer, includes $60,000 in gross income as a constructive dividend for the tax year. To the extent Jordan has paid any foreign income taxes, Taylor may claim a deemed-paid foreign tax credit for the portion of the foreign taxes related to the $60,000 constructive dividend. ■

A CFC is any foreign corporation in which more than 50 percent of the total combined voting power of all classes of stock entitled to vote or the total value of the stock of the corporation is owned by U.S. shareholders on any day during the taxable year of the foreign corporation. The foreign subsidiaries of most multinational U.S. parent corporations are CFCs.

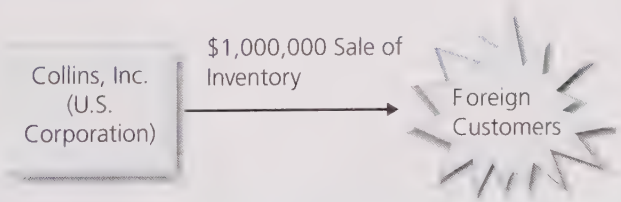
For purposes of determining if a foreign corporation is a CFC, a **U.S. shareholder** is defined as a U.S. person who owns, or is considered to own, 10 percent or more of the total combined voting power of all classes of voting stock of the foreign corporation. Stock owned directly, indirectly, and constructively is counted. Indirect ownership involves stock held through a foreign entity, such as a foreign corporation, foreign partnership, or foreign trust. This stock is considered to be actually owned proportionately by the shareholders, partners, or beneficiaries. Constructive ownership rules, with certain modifications, apply in determining if a U.S. person is a U.S. shareholder, in determining whether a foreign corporation is a CFC, and for certain related-party provisions of Subpart F.

A U.S. shareholder of a CFC does not necessarily lose the ability to defer U.S. taxation of income earned by the CFC. Only certain income earned by the CFC triggers immediate U.S. taxation as a constructive dividend. This tainted income, referred to as Subpart F income, can be characterized as income that is easily shifted or has little or no economic connection with the CFC's country of incorporation. Examples include:

- Passive income such as interest, dividends, rents, and royalties.
- Sales income where neither the manufacturing activity nor the customer base is in the CFC's country and either the property supplier or the customer is related to the CFC.
- Service income where the CFC is providing services on behalf of its U.S. owners outside the CFC's country.

EXAMPLE 17

Collins, Inc., a domestic corporation, sells $1 million of its products to customers in Europe. All manufacturing and sales activities take place in the United States. Collins has no employees, assets, or operations in Europe and thus is not subject to income tax in any European jurisdiction.



Collins reported the following tax consequences from these inventory sales.

Sales revenue	$1,000,000
Cost of goods sold	(600,000)
Net income	$ 400,000
U.S. tax at 35%	$ 140,000

Assume that Collins instead creates a wholly owned foreign subsidiary in the Cayman Islands, where no income taxes are imposed on corporate income. Collins then sells the inventory to the subsidiary at an intercompany transfer price of $700,000, and the

TAX in the NEWS

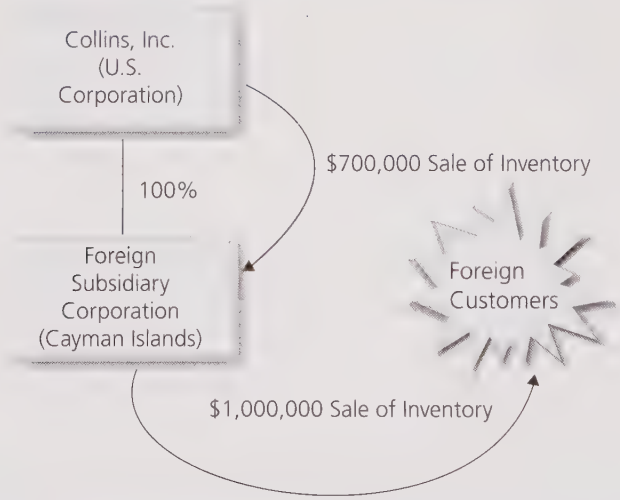
Bring It on Home

A one-time opportunity to bring offshore profits home to the United States was provided in a 2004 tax law change. Section 965 allowed U.S. shareholders of foreign corporations to repatriate certain profits of their foreign subsidiaries and receive an 85 percent dividends received deduction. At a 35 percent tax rate, these recipients paid a U.S. tax of only 5.25 percent (35% × 15%) on the repatriated amount.

Many U.S. corporations thought this was a great idea. According to the IRS, based on filings of *Form 8895, One-Time Dividends Received Deduction for Certain Cash Dividends from Controlled Foreign Corporations*, U.S. corporations brought home $362 billion in cash dividends eligible for this special deduction. Foreign subsidiaries in the Netherlands provided the largest percentage of repatriated profits (26 percent), with Switzerland the next most popular (9.9 percent). The next largest source of repatriated profits was Bermuda, with 9.6 percent.

Source: IRS, Statistics of Income Division, February 2008, **www.irs.gov/taxstats/bustaxstats/article/0,,id=180693,00.html**.

subsidiary sells the inventory to the ultimate European customers for $1 million. The subsidiary does not further process the inventory and is only minimally involved in the sales function, as Collins' employees arrange the transactions with the ultimate customers. In essence, the sale to the subsidiary is simply a "paper" transaction.



If there were no tax law restrictions, this structure would create the following tax consequences.

	Collins, Inc.	Foreign Subsidiary
Sales revenue	$ 700,000	$ 1,000,000
Cost of goods sold	(600,000)	(700,000)
Net income	$ 100,000	$ 300,000
U.S. tax at 35%	$ 35,000	
Foreign tax at 0%		$ –0–

Because the Cayman Island subsidiary is not engaged in a U.S. trade or business, it is not subject to any U.S. tax on its income. So long as the subsidiary's profits are kept outside the United States, Collins believes it can avoid any U.S. income tax on these profits (i.e., the deferral privilege). Thus, at first glance it appears that using the foreign subsidiary significantly reduces Collins' current tax cost from $140,000 to $35,000.

However, Collins will find this strategy attacked by the U.S. taxing authorities on two fronts, either of which results in the loss of all or most of the tax savings.

TAX FACT

Who Are These CFCs?

The 7,500 largest CFCs accounted for $5.8 trillion of the assets and more than $2.3 trillion of the gross receipts of all CFCs during the latest year for which complete data are available. These CFCs were engaged primarily in manufacturing (29 percent), services (26 percent), or finance, insurance, or real estate (24 percent). Although these 7,500 CFCs were incorporated in over 100 different countries, CFCs in Europe, Canada, and Japan accounted for over 80 percent of the gross receipts. In 2002, CFCs distributed $97 billion of profits to their U.S. parents and other shareholders. A "large" CFC is one having $500 million or more in assets.

Source: *Statistics of Income Bulletin*, **www.irs.gov/pub/irs-soi/02cfcart.pdf.**

First, the IRS may use the transfer pricing rules of § 482 to claim that the $700,000 intercompany transfer price between Collins and its subsidiary is not a correct **arm's length price**. The IRS may claim that the transfer price should be $1 million because the subsidiary does not add any value to the inventory through further processing or sales activities and all the risks of the transaction are borne by Collins. With this transfer pricing adjustment, Collins will have a $400,000 profit from the sales and the same $140,000 tax cost as if it had not used the foreign subsidiary as an intermediary.

Determining a correct transfer price is a very subjective exercise. Accordingly, Congress enacted the Subpart F provisions to create more certainty in the effort to prevent unwarranted tax benefits from accruing to U.S. taxpayers using offshore subsidiaries to shield profits from the reach of the U.S. tax authorities. Under the Subpart F rules, the subsidiary's $300,000 income creates a constructive dividend for Collins, thus producing a $105,000 tax cost ($300,000 × 35%). Combined with its original $35,000 tax, Collins' total tax cost for the sales is $140,000 ($35,000 + $105,000), and the use of the foreign subsidiary does not achieve any tax savings. ■

EXAMPLE 18

Assume that in Example 17 Collins' foreign subsidiary instead was incorporated in Ireland, where the tax rate on such sales income is 12.5%. The subsidiary purchases raw materials from Collins and performs substantial manufacturing activity in Ireland before selling the inventory to customers in Hong Kong. In this case, the sales income is not Subpart F income. Even without the manufacturing activity, sales to customers within Ireland would not produce Subpart F income. In both instances, there is economic substance to the non-U.S. subsidiary earning the income. The fact that the Irish subsidiary pays a substantially lower tax rate than the U.S. parent does not by itself trigger a constructive dividend. However, Collins must still document the appropriateness of its intercompany transfer price on raw material sales to its Irish subsidiary. ■

The Subpart F provisions are quite complex and subject to numerous exceptions. But, in general, any time a CFC earns income that has little economic connection to its local country, the income is potentially tainted income under Subpart F and will generate a constructive dividend to the CFC's U.S. shareholders. Alternatively, if the CFC is actively generating the income, it is likely not Subpart F income. Unfortunately, the mechanistic application required by the Subpart F provisions sometimes catches active foreign corporations within the Subpart F web.

EXAMPLE 19

Murphy, Inc., a U.S. corporation owns all of GreenCo, Ltd., an Irish manufacturing corporation, and SwissCo, a Swiss distribution corporation. Both GreenCo and SwissCo are CFCs. GreenCo sells its inventory production to SwissCo. SwissCo sells the inventory to unrelated customers located in Switzerland, Italy, and Germany. Because SwissCo does not

manufacture the inventory and acquires it from a related supplier, any sales to customers outside Switzerland will produce Subpart F income and a constructive dividend to Murphy, Inc. This is true even though SwissCo is engaged in an active business and is not merely a "paper" corporation. To avoid Subpart F treatment, Murphy, Inc., should create a distribution company within each country where it operates to sell to customers only within that country. ■

Tax Planning Strategies AVOIDING CONSTRUCTIVE DIVIDENDS

FRAMEWORK FOCUS: TAX CREDITS

Strategy: Maximize Deductible Amounts.

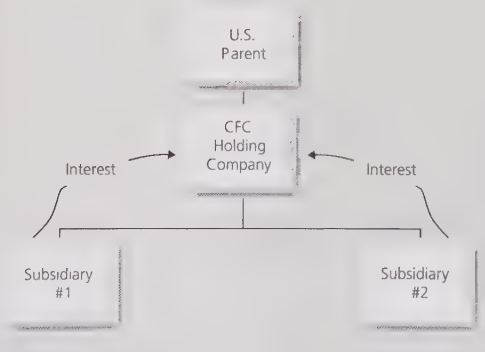
To defer U.S. taxes on foreign income, U.S. taxpayers often create separate foreign subsidiaries to hold their foreign operations. This approach is successful so long as the foreign subsidiaries do not pay dividends to the U.S. owners and do not earn Subpart F income that creates constructive dividends. U.S. companies often set up foreign holding companies in tax-favorable jurisdictions to hold the foreign operating subsidiaries.

For example, a U.S. parent might create a CFC holding company to hold its two operating subsidiaries. The subsidiaries both pay interest to the holding company on intercompany loans. The interest is deductible by the operating subsidiaries at a high tax rate (providing tax savings in those countries) and is taxed to the holding company at a relatively low tax rate. This approach provides a net tax savings to the foreign group. However, the interest payments to the holding company may constitute Subpart F income and trigger a constructive dividend back to the U.S. parent. If so, the tax savings related to the intercompany loans are offset by the U.S. taxes on the Subpart F income.

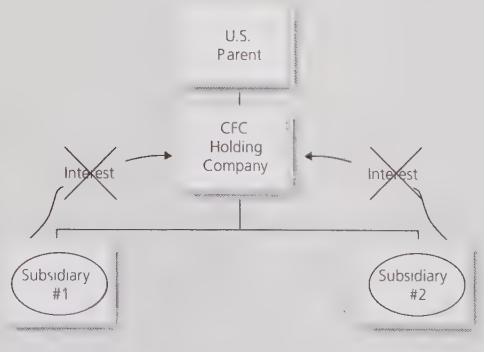
Fortunately, a mechanism exists that allows the holding company to avoid Subpart F treatment for the interest income. The **check-the-box** Regulations under § 7701 provide a great deal of flexibility for U.S.-based multinational corporations. For example, corporations are allowed to elect (i.e., check the box on a form) to treat certain foreign subsidiaries as unincorporated branches for U.S. purposes rather than separate legal entities. This election does not change the treatment of the entities under local tax law.

Using the check-the-box rules, the U.S. parent can elect to treat the foreign subsidiaries as branches for U.S. purposes. In this case, the two foreign subsidiaries are treated as mere divisions of the holding company. Accordingly, the intercompany loans do not exist from a U.S. perspective, and there is no interest income because the interest payments are treated as simply fund transfers within a single corporation. Without the interest income, there is no Subpart F income and thus no constructive dividends. However, the foreign tax savings still exist because the interest payments do exist from a foreign tax perspective and continue to provide interest deductions at the subsidiary level.

Without "Check-the-Box"



With "Check-the-Box"



TAX in the NEWS

A Deferral for an End to Deferral?

The Obama administration is interested in reforming the U.S. taxation of foreign income, with a particular concern about scaling back the benefits resulting from the deferral of income earned by the foreign subsidiaries of U.S. corporations. Only a few months after President Obama's inauguration, the Treasury Department released *General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals*. This publication—widely known as the "Green Book"—outlined several far reaching proposed changes to the U.S. international tax rules.

Key ideas of the Green Book included reducing the availability of the "check-the-box" election, disallowing certain U.S. tax deductions until associated foreign income is repatriated, and reducing the ability for certain planning opportunities involving the foreign tax credit. The net effect of these changes would be an increase in the U.S. tax on the foreign profits of U.S. corporations.

Apparently as a result of extensive lobbying efforts by U.S. multinationals, the administration decided to delay international tax reform until a later date. Notwithstanding this delay, it seems clear that international tax reform is on the horizon.

Inbound Issues

LO.4

Describe the tax effects related to the U.S. operations of a non-U.S. taxpayer.

Generally, only the U.S.-source income of nonresident alien individuals and foreign corporations is subject to U.S. taxation. This reflects the reach of the U.S. tax jurisdiction. This constraint, however, does not prevent the United States from also taxing the foreign-source income of nonresident alien individuals and foreign corporations when that income is effectively connected with the conduct of a U.S. trade or business.

A **nonresident alien (NRA)** is an individual who is not a citizen or resident of the United States. Citizenship is determined under the immigration and naturalization laws of the United States. Residency is determined under § 7701(b). A person is treated as a resident of the United States for income tax purposes if he or she meets either the green card test or the substantial presence test. If either of these tests is met for the calendar year, the individual is deemed a U.S. resident for the year. Section 7701(a)(5) defines a foreign corporation as one that is not domestic.

Two important definitions determine the U.S. tax consequences to foreign persons with U.S.-source income: "the conduct of a U.S. trade or business" and "**effectively connected income**." Specifically, for a foreign person's noninvestment income to be subject to U.S. taxation, the foreign person must be considered engaged in a U.S. trade or business and must earn income effectively connected with that business. General criteria for determining if a U.S. trade or business exists

TAX Fact

The Inbound Sector

Overseas entities that are subject to the Federal income tax file their operating results on Form 1120-F. Summary statistics from these returns (see table) indicate that inbound operations produce a small but significant portion of U.S. income tax collections.

With an average U.S. income tax rate of about 25 percent, perhaps some of the other countries in the world look at the United States as a tax haven!

Number of Forms 1120-F filed	12,650
Taxable income reported	$4.8 billion
Net tax liability before credits	$1.44 billion
Net tax liability after credits, primarily the foreign tax credit	$1.2 billion

CONCEPT SUMMARY 13.1

U.S. Tax Treatment of Foreign Person's Income

Type of Income	Tax Rate
U.S.-source fixed, determinable, annual, or periodic (FDAP) income (not effectively connected to a U.S. business)	Generally 30% withholding on gross amount (or lower treaty rate) with certain limited exceptions.
U.S.-source income effectively connected with a U.S. trade or business	Regular individual or corporate rates applied against net income (after deductions).
Gain on U.S. real property (direct or indirect interest)	Taxed as if effectively connected to a U.S. trade or business.
Capital gains (other than on U.S. real property) not effectively connected to a U.S. trade or business	Foreign corporation: Not subject to U.S. tax. Individual: Generally not taxed but may be subject to a 30% U.S. tax if taxpayer is physically present in the United States for 183 days or more in a taxable year.
Foreign-source business income	Generally not subject to U.S. taxation unless attributable to a U.S. office or fixed place of business.

include the location of production activities, management, distribution activities, and other business functions. The Code does not explicitly define a U.S. trade or business, but case law has described the concept as activities carried on in the United States that are regular, substantial, and continuous. Once a foreign person is considered engaged in a U.S. trade or business, all U.S.-source income other than investment and capital gain income is considered effectively connected to that trade or business and is therefore subject to U.S. taxation. Effectively connected income is taxed at the same rates that apply to U.S. persons, and deductions for expenses attributable to that income are allowed.

Certain U.S.-source income that is *not* effectively connected with the conduct of a U.S. trade or business is subject to a flat 30 percent tax. This income includes dividends, interest, rents, royalties, certain compensation, premiums, annuities, and other fixed, determinable, annual or periodic **(FDAP)** income. This tax generally is levied by a withholding mechanism that requires the payors of the income to withhold 30 percent of gross amounts (or a lower rate as established by a treaty). This method eliminates the problems of assuring payment by nonresidents and foreign corporations.

EXAMPLE 10

Robert, a citizen and resident of New Zealand, produces wine for export. During the current year, Robert earns $500,000 from exporting wine to unrelated wholesalers in the United States. The title to the wine passes to the U.S. wholesalers in New York. Robert has no offices or employees in the United States. The income from the wine sales is U.S.-source income, but because Robert is not engaged in a U.S. trade or business, the income is not subject to taxation in the United States.

Robert begins operating a hot dog cart in New York City. This activity constitutes a U.S. trade or business. Consequently, all U.S.-source income other than FDAP or capital gain income is taxed in the United States as income effectively connected with a U.S. trade or business. Thus, both the hot dog cart profits and the $500,000 in wine income are taxed in the United States. ■

Several exceptions exempt foreign persons from U.S. taxation on their U.S. investment income that is not connected with a U.S. business. For example, certain U.S.-sourced portfolio debt investments and capital gains (other than gains on U.S. real property investments) are exempt from U.S. tax for most foreign investors. Gains from investments in U.S. real property (held directly or indirectly through

other entities) are subject to U.S. taxation. Concept Summary 13.1 summarizes the U.S. taxation of foreign persons.

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft.**



13.3 Crossing State Lines: State and Local Income Taxation in the United States

Very few taxpayers sell goods and services solely in the U.S. state in which they are based. Sales in other states are attractive for a variety of business reasons, including the expansion of market share and the achievement of economies of scale. By extending its operations into other states, a firm may be able to lower its labor and distribution costs, obtain additional sources of long-term debt and equity, and perhaps find a more favorable tax climate.

Many of the same issues discussed earlier in the chapter concerning international operations are encountered when a multistate operation is in place. Both international and multistate operations raise basic questions such as where did the transaction occur and who is liable for the collection of the tax.

However, as state and local income taxation has evolved within the United States, differences in terminology, definitions, and scope of the tax have arisen. Although prior knowledge of the U.S. international tax regime can be helpful in studying the state and local income tax structure, there still is much to learn. In addition, the sheer number of income taxing districts at the state and local level make an encounter with the state and local income tax laws of the United States a challenging experience.

SOURCES OF LAW

LO.5

Identify the sources of tax law applicable to a taxpayer operating in more than one U.S. state.

Think of how complicated a tax professional's work would be if there were several hundred different Internal Revenue Codes, each with its own Regulations, rulings, and court decisions. That description is hardly an exaggeration of the state and local income tax law faced by a taxpayer operating in more than one jurisdiction. Unless a firm's salable goods or services are designed, made, and sold strictly within one taxing jurisdiction, the multistate regime comes into effect.

Almost every U.S. state taxes the business income of proprietors, corporations, and other entities that have a presence in the state.[8] Those states all have constitutional provisions allowing an income tax and aggregated legislation defining the tax base, specifying when the tax is due and from whom, and otherwise administering the tax. A separate revenue department interprets the law and administers the annual taxing process.

Every one of these systems is distinct and different in multiple ways—the name and location of the chief tax official, the definitions of what is taxable and deductible and what is not, the due dates and filing requirements applicable to the tax, and the taxpayer-friendliness of the audit and appeals system.

Despite the no-new-taxes pledge of many politicians on election day, income taxes are still popular in the United States. Income taxes are levied by states, cities, counties, villages, commuter districts, stadium boards, and numerous other bodies that have been granted taxing authority by their states. And politicians think that they can gain economic development advantages over their neighbors by granting special

[8]Some states tax the investment income of individuals, but those taxes are not addressed in this chapter. Nevada, South Dakota, Washington, and Wyoming do not have a corporate income tax. Washington uses a business and occupation tax, and several states impose a tax on the gross receipts of a business.

tax breaks—"Locate your assembly plant here and we'll exempt one-half of your employees' wages from the state income tax"—so the laws are constantly changing. By one estimate, a business taxpayer might be exposed to almost 500 different income taxing jurisdictions in the United States.

The Federal government has stayed out of the fray and has not attempted to force states and localities to use a single common tax formula and administrative organization. Only in **Public Law 86–272** has Congress attempted to bring order to the multistate income tax process. This 1957 pro-interstate commerce provision exempts from state and local taxation a sale of tangible personal property where the only contact with the state was the **solicitation** activity of the taxpayer.

In the past 20 or 30 years, the states have taken some steps to coordinate their activities. Several groups of states exchange information as to the seller and purchase price for cross-border sales, so that income and sales/use tax obligations can be computed and collected properly. A few states have reciprocity arrangements with their neighbors so as to straighten out the complications that can arise when an employee lives in one jurisdiction but works in another.

EXAMPLE 21

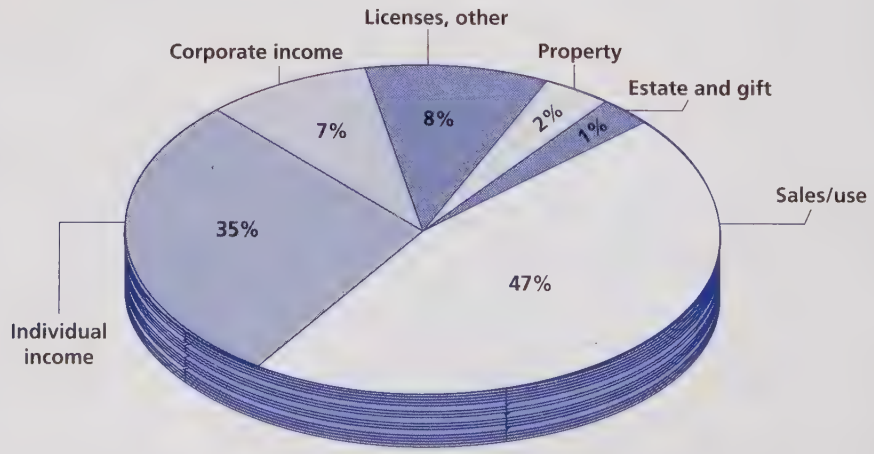
Harry works at the Illinois plant of Big Corporation, but he lives in Iowa. His wages are subject to Iowa tax. If Illinois and Iowa had a reciprocity agreement in place, either (1) Big would collect and remit income tax at Iowa's rates and remit the tax to the Iowa revenue department, or (2) Big would collect Illinois tax, and that state would keep the withholdings paid, in full satisfaction of Harry's Iowa tax obligations for the year. ■

About half of the states are members of the **Multistate Tax Commission (MTC)**, a body that proposes legislation to the states and localities and issues its own regulations and informational materials. A majority of the non-MTC members follow the agency's rules virtually without exception. The Uniform Division of Income for Tax Purposes Act (UDITPA) is made available to states and localities interested in a coherent set of income assignment rules, and it forms the basis for the income tax statutes in most of the MTC member states.

TAX FACT

STATE TAX REVENUE SOURCES

The corporate income tax accounts for only a small portion of total tax revenues of the states. For 2006, almost $700 billion in taxes were collected by the states (i.e., over $2,000 per person).



TAX in the NEWS

So Where Did You Work Today?

It is the dream of many intellectual-property employees to work at home with the employer's computer and communications equipment. Not only is the dress code there targeted to the worker's comfort, but the employee can avoid the time and cost of commuting. The employer saves by not having to provide office space.

But what are the tax effects when the employee or independent contractor submits work to an employer located in a different state? The general rule has been that state income taxes fall in full in the state where the work is done. Is this still the rule, or must the employee apportion the hours of the day among the various states that receive the work product? If so, on what basis should such apportionment be made? Furthermore, how will the worker reduce any potential taxation of the same income by more than one state?

A few states and cities, most notably in New York, are aggressively trying to impose income taxes on the work of telecommuters that enters the state. In these situations, enough nexus purportedly exists to permit the levying of income taxes on telecommuters based in other states. The finding of nexus with New York (both the city and the state) can be an expensive proposition for the worker and employer.

For now, it will be up to the states considering this form of taxation to decide if the additional revenue is worth the risk of angering the desirable high-tech, information workers who play a large role in our economy.

The MTC, which provides very specific formulas and definitions to be used in computing state taxable income, is as close as the states have come so far to a multilateral tax treaty process. If all states and localities followed all of the MTC rules, taxpayers would be unable to gain any "border advantages" or disadvantages. But political concerns likely will keep this coordinated result from ever happening.

TAX ISSUES

The key issues facing a state or locality in drafting and implementing an income tax model are the same as those facing the international tax community. The results of the deliberative process, though, have produced somewhat different sets of rules and terminology.

Authority to Tax

A business is taxable in the state in which it is resident, organized, or incorporated. Tax liabilities also arise in other jurisdictions where **nexus** exists; that is, a sufficient presence in the other state has been established on an ongoing basis. Such presence might come about because the corporation was organized there, the proprietor lives there, an in-state customer made a purchase, or the business employed people or equipment within the borders of the state. The precise activities that create nexus vary from jurisdiction to jurisdiction, although most of the taxing states follow the broad rules of Public Law 86–272 and the regulations of the MTC.[9]

When a taxpayer operates in more than one state, total taxable income for the year is split among the jurisdictions in which the operations take place. Portions of the total income amount are assigned to each of the business locations, so several tax returns and payments will be due. For a taxpayer considering an expansion of operations, the tax adviser can make an important contribution in helping to decide with which state(s) nexus will be created.

The nexus rules of state/local taxation serve much the same function as do the permanent establishment provisions of international taxation. The PE standards are

[9]Income and sales/use tax regimes use different nexus standards. Generally, it has been "easier" to establish nexus for sales/use tax purposes; most states have a separate set of rules to determine the taxability of income or a transaction. But recent U.S. Supreme Court cases seem to apply a "physical presence" test for the sales/use tax, a somewhat stricter and smokestack-industry test than the income tax nexus rules of the MTC. This chapter concentrates on income tax nexus provisions for the most part.

Tax Planning Strategies NEXUS: TO HAVE OR HAVE NOT

FRAMEWORK FOCUS: TAX RATE

Strategy: Shift Net Income from High-Tax Jurisdictions to Low-Tax Jurisdictions.

Most taxpayers try to avoid establishing nexus in a new state, for example, by providing a sales representative with a cash auto allowance rather than a company car, by restricting the situs of inventory to only a few states, or by limiting a sales person's activities to those that are protected by the solicitation standard of Public Law 86–272. This effort to avoid nexus stems in part from the additional compliance burden that falls upon the taxpayer when a new set of income tax returns, information forms, and deadlines must be dealt with in the new state.

Another concern is that the marginal tax rate that applies to the net taxable income generated by the taxpayer may increase. Such a tax increase occurs, of course, only when the applicable tax rate in the new state is higher than the rate that would apply in the home state. If a business already is based in a tax-friendly state such as Alabama or Illinois or in a no-tax state such as Nevada, its aggregate tax liability is sure to increase.

Still, nexus is not necessarily a bad thing. Consider what happens if a business based in Minnesota, Massachusetts, Wisconsin, or another high-tax jurisdiction purposely creates nexus in a low- or no-tax state. If the new state applies a lower marginal rate than is available in the home state, or offers special exemptions or exclusions that match the taxpayer's operations, the aggregate tax bill can decrease. Then the planning efforts include determining which activities will *create* nexus in the new jurisdiction and meeting or maintaining that standard.

For instance, an entertainer based in Manhattan is subject to the relatively high income taxes of New York City and New York State. By establishing a permanent office in Tennessee, nexus will be created, and some portion of the taxpayer's income will subject to taxation there, instead of in New York. These are permanent savings, accruing immediately to after-tax income and the share price of the stock of the taxpayer.

based in the language of the applicable tax treaty and interpretive court decisions. They look for real estate holdings and manufacturing equipment. Permanent establishment is found when an office in the host country participates significantly in the making of a sales or service contract.

DIGGING DEEPER 3

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

LO.6

Apply computational principles designed for a taxpayer operating in more than one U.S. state.

Income Sourcing

The multistate business, like its international counterpart, must divide up the taxable income generated for the year among the states in which it operates. Then tax liability is computed for the states in which nexus has been established. The computational template illustrated in Figure 13.2 indicates how most states derive their shares of the entity's aggregate taxable income. Usually, the starting point for this computation is Federal taxable income.

State modification items come about because each state creates its own tax base in the legislative process, and some of the rules adopted may differ from those used in the Internal Revenue Code. The modification items reflect such differences in the tax base. For example, modifications might be created to reflect the following differences between state and Federal taxable income.

- The state might allow a different cost recovery schedule.
- The state might tax interest income from its own bonds or from those of other states.
- The state might allow a deduction for Federal income taxes paid.
- The state might disallow a deduction for payment of its own income taxes.

FIGURE 13.2 Computing State Income Tax Liability

	Federal taxable income
±	State modification items
	State tax base
±	Nonbusiness income/loss (for allocation)
	Business income (for apportionment)
×	Apportionment percentage for the state
	Taxable income apportioned to the state
±	Taxable income/loss allocated to the state
	State taxable income/loss
	State tax, per tax table or rate schedule
–	State's tax credits
	Net state tax liability

- The state might allow a net operating loss (NOL) deduction only for losses generated in the state.
- The state's NOL deduction might reflect different carryover periods than Federal law allows.

State tax modifications are made even if the taxpayer operates only in its home state.

The next step in computing state taxable income is to **allocate** items of nonbusiness income and loss to the states in which such items are derived. For instance, a Kansas entity might recognize some net income from the rental of a Missouri office building to a tenant. The net rental amount is in Federal taxable income, but it must appear only and fully in Missouri taxable income. So, by means of the modification process, the rents are removed from the taxable income for both states and then added back into Missouri taxable income. The allocation process is very much like the income-sourcing procedures employed in international taxation.

EXAMPLE 13

HammerCo reports $400,000 in taxable income for the year from its sales operations, based exclusively in Mississippi and Arkansas. HammerCo recognized net rent income of $60,000 from a building it owns in Mississippi. It earned $20,000 in interest income from Arkansas bonds. This amount is excluded from Federal taxable income, and it is taxed by Mississippi but not Arkansas. HammerCo also claimed a Federal NOL carryforward of $75,000 from a prior period. Mississippi follows Federal law for NOLs, but Arkansas does not allow such carryovers at all. The modifications to the state tax base are as follows.

Mississippi		Arkansas	
Amount	**Modification**	**Amount**	**Modification**
– $60,000	Total nonbusiness income	– $60,000	Total nonbusiness income
+ $20,000	Municipal bond interest income	+ $75,000	Remove Federal NOL deduction
+ $60,000	Net rent income from Mississippi rentals		

■

The business income of the taxpayer is **apportioned** among the states in which it operates. The apportionment percentage for the state is multiplied times the business income of the taxpayer to measure the extent of the taxpayer's exposure to the state's income tax. The application of the apportionment percentage is illustrated in Figure 13.2.

Most states apply an apportionment procedure involving three factors, each meant to estimate the taxpayer's relative activities in the state.

- The **sales factor** = In-state sales/total sales.
- The **payroll factor** = In-state payroll/total payroll.
- The **property factor** = In-state property/total property.

The state's apportionment percentage is the average of these three factors. This three-factor apportionment can be traced to the earliest days of state income taxation. Today, most states add additional weight to the sales factor, believing it to be the most accurate and measurable reflection of the taxpayer's in-state activities. It is common to "double-weight" the sales factor. A few states use only the sales factor in the apportionment procedure.

EXAMPLE 13

LinkCo, Inc., operates in two states. It reports the following results for the year. LinkCo's apportionment percentages for both states are computed as shown. Amounts are stated in millions of dollars.

	State A	State B	Totals
Sales	$30	$20	$50
Payroll	40	20	60
Property	45	5	50
Sales factor	$30/$50 = .6	$20/$50 = .4	
Payroll factor	$40/$60 = .67	$20/$60 = .33	
Property factor	$45/$50 = .9	$5/$50 = .1	
Apportionment percentage	(.6 + .67 + .9)/3 = .72	(.4 + .33 + .1)/3 = .28	

Note that 100% of the business income is apportioned between the two states: 72% to State A and 28% to State B.

Now assume that State A double-weights the sales factor. LinkCo's apportionment percentages are computed as follows.

	State A	State B	Totals
Sales	$30	$20	$50
Payroll	40	20	60
Property	45	5	50
Sales factor	$30/$50 = .6	$20/$50 = .4	
Payroll factor	$40/$60 = .67	$20/$60 = .33	
Property factor	$45/$50 = .9	$5/$50 = .1	
Apportionment percentage	(.6 + .6 + .67 + .9)/4 = .69	(.4 + .33 + .1)/3 = .28	

State B's apportionment computations are not affected by A's double-weighting of the sales factor. The percentages now do not total to 100%. The effect of the special weighting is to reduce LinkCo's tax liability in A. This is likely LinkCo's "home state" given the location of its personnel and plant and equipment.

Finally, assume that State B uses a "sales-factor-only" weighting. The A apportionment percentage is .69, and the B percentage is .4. Now the apportionment percentages *exceed* 100%. ■

Most states follow the regulations of the MTC and the outline of the UDITPA in defining and applying the apportionment factors. But because the states do not follow identical rules in the makeup of the factors, the apportionment percentages

TAX in the NEWS

State Deficits Change How Revenue Departments Work

The current crunch in state budget making has lasted for several years, and new sources of revenue and new attitudes toward enforcement are prime goals of state and local operations.

Much of this budget squeeze has been felt in the increased attention toward sales and use taxes, with many states now dedicating more resources toward those taxes than toward the individual and corporate income taxes. Collecting unpaid use taxes on Internet and mail-order sales and finding new taxpayers to add to the income and sales/use tax rolls are prime enforcement targets for many states.

But a sustained revenue shortfall tends to make some revenue departments either more desperate or more creative. In either event, we can observe the use of new or recycled approaches to tax enforcement that can surprise the taxpayer who has not been paying attention. Some of the techniques observed lately include the following.

- Applying local business and occupation taxes, payroll taxes, and license fees to telecommuters and work-at-home entrepreneurs and creative workers.
- Increasing audit staff and travel resources, resulting in increased and better-targeted auditing of returns.
- Temporary increases in underpayment and nonfiling fines and penalties, and reductions in grace periods for late filing or payment.
- Denial of other licenses and permits (like hunting and boating permissions, driver's licenses, and professional certifications) where income and sales/use taxes are underpaid.
- Adding "unpaid use tax" lines to the income tax return. This does result in some revenue collected from taxpayers who have guilty consciences or high levels of integrity, but mainly it sets up the taxpayer for penalties on a later audit, when the sworn-to-be-complete income tax return shows a zero balance on the use tax line.
- Refusing legislatively to adopt certain Federal tax breaks, such as special cost recovery elections or the increases in deductible or tax-deferred retirement and education allowances.
- Increased use of private collection agencies to find delinquent taxpayers and produce dollars for the state treasury.

seldom total precisely to 100 percent. Some other aspects of the three-factor approach include the following.

- Sales are assigned using the tax accounting methods of the taxpayer. Sales are assigned using the "ultimate destination" concept; that is, a sale is usually assigned to the state of the purchaser.
- If a sale is made into a state with no income tax or a state with which the taxpayer has not established nexus, tax is likely escaped. But over a third of the states apply a **throwback rule** that causes the sale to be sourced to the state of the seller (i.e., by overriding the "ultimate destination" rule).
- Payroll is assigned to the state in which the employee's services primarily are performed. Payroll includes wages, bonuses, commissions, and taxable fringe benefits. Some states exclude officer compensation because it can distort the computations. Some states exclude contributions to a § 401(k) plan.
- The property factor uses an average historical cost basis, net of accumulated depreciation. Idle property is ignored, but construction in progress is included. Property in transit is assigned to the state of its presumed destination.
- Property leased but not owned by the taxpayer is included in the property factor at eight times the annual rentals paid.

Many states use specialized apportionment percentages for industries whose sales and asset profile is not properly reflected in the traditional three-factor formula.

For instance, the airline industry might divide its income based on passenger-miles beginning and ending in the state. Truckers might be able to divide taxable income among the states based on in-state vehicle-trips or tons-per-day. Communications companies might use the in-state miles of cable or number of wireless devices to make up an apportionment formula.

About 20 states use a **unitary approach** to computing the apportionment factors. Conglomerates are required, or can elect, to base their computations on the data for all of their affiliated corporations, not just the legal entities that do business with the state. Affiliates included under the unitary theory share a majority ownership with a parent or group of shareholders. They also often share data processing, sales force, and marketing resources.

The *combined return* that the unitary business files includes much more data than might be expected on a separate-entity basis, but the taxing jurisdictions often believe that the unitary figures offer a more accurate reflection of the taxpayer's activity within the state and that, therefore, a more accurate tax liability can be derived.

EXAMPLE 24

Kipp Industries is a holding company for three subsidiaries: GrapeCo operating in California, PotatoCo operating in Idaho, and BratCo operating in Germany. Only GrapeCo has nexus with California. But because California is a unitary state, the California apportionment percentage is computed also using PotatoCo and BratCo data. ■

EXAMPLE 25

Return to the facts of Example 24. If Kipp Industries files a waters'-edge election, the unitary group that files a California income tax return can be limited to GrapeCo and PotatoCo. ■



In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

Tax Planning Strategies WHERE SHOULD MY INCOME GO?

FRAMEWORK FOCUS: TAX RATE

Strategy: Shift Net Income from High-Tax Jurisdictions to Low-Tax Jurisdictions.

Every state defines its apportionment factors in a slightly different manner. The multistate taxpayer needs to keep track of these differences and place activities in the state that will serve them best.

Planning with the sales factor includes a detailed analysis of the destination point of the product shipments for the year, especially when the firm has customers in low- and no-tax states. The property factor should include only assets that are used in the taxpayer's trade or business, not the investment, leasing, or research functions. Permanently idle property is excluded from the property factor as well. The payroll factor can be manipulated by hiring independent contractors to carry out certain sales and distribution work, or by relocating highly paid managers to low-tax states.

By setting up an investment holding company in a no- or low-tax state, such as Delaware or Nevada, and transferring income-producing securities and intangible assets to that entity, significant tax reductions can be obtained. When the net investment income is paid back to the parent corporation, the dividends received deduction eliminates the tax liability there.

The unitary system does not always result in a tax increase, although the additional record-keeping burden of operating in a unitary state cannot be understated. If the affiliates make available less profitable operations or a presence in low- or no-tax states or countries, the current tax liability may be reduced. The record-keeping burden can be reduced if the taxpayer makes a **waters'-edge election**, which allows it to include only affiliate data from within the boundaries of the United States.



CONCEPT SUMMARY 13.2

Corporate Multistate Income Taxation

1. A taxpayer is subject to income tax in the state in which it resides or is organized.
2. A taxpayer is subject to income tax in states where it has a business presence and enjoys the resources of the host state in conducting its operations.
3. A multistate taxpayer must divide its aggregate taxable income for the year among the states in which it conducts business.
4. Nonbusiness income is allocated to the state in which it is generated.
5. Business income is apportioned among the states in which the taxpayer has nexus.
6. Apportionment usually is conducted using a formula based on the relative sales, employment, and asset holdings in the various states.
7. The sales factor uses a destination test, while the payroll and property factors use a source test.
8. Most states weight the sales factor higher than the other apportionment factors.
9. Some states apply a special apportionment formula for certain industries, when the traditional three-factor formula could distort the income division procedure in some way.
10. About 20 states employ the unitary theory in deriving the apportionment factors, using the data from a group of corporations to compute the apportionment formula. Other states allow or require a consolidated return from a conglomerate.

13.4 Common Challenges

LO.7

Synthesize the international and multistate tax systems and recognize common issues faced by both systems.

Practical and policy issues facing the U.S. states, developed countries, and the taxpayers operating in all of them show a great degree of similarity between the multistate and international tax regimes. Terminology may differ, and the evolution of tax solutions may take radically different paths, but the key issues that face the multijurisdictional community are at once challenging and rewarding.

AUTHORITY TO TAX

The old-economy orientation of the nexus and permanent establishment rules presents great difficulty in today's economy, as jurisdictions attempt to describe the income and sales/use tax base fairly. An electronic presence also exploits the resources of the host country and should trigger a tax in the visited jurisdiction. Mathematically, the apportionment and sourcing rules should result in only a modest tax liability in the host jurisdiction, but to maintain that no presence exists and no tax should be paid in the context of an 800 telephone number or Internet sale is improper.

But perhaps the notion of *presence* is becoming less important over time, and the level of resource usage in the host jurisdiction also is declining. For example, just-in-time manufacturing and purchasing strategies reduce the need for warehousing by some taxpayers. Human capital can be dispersed through telecommuting, video conferencing, and project rotation using work-group software that provides acceptable levels of data security. If the future is to a great degree wireless, perhaps the standard of presence will diminish, as the buyer and the seller are both "everywhere."

DIVISION OF INCOME

The multistate apportionment procedure could use an overhaul. The fact that a majority of states change the weighting of the sales factor indicates that some other income division method might better serve taxpayers and governments.

TAX in the NEWS

Finding New Revenues

Some states have used statistical sampling for many years in such applications as auditing receivables collected or taxable sales transactions. Taxpayers have sued in several states to prevent or restrict the use of sampling, but if the judge can understand the basic purpose and proper use of sampling, the state is allowed to use the technique.

"Data mining" is another new audit strategy used by the states. Usually, data mining includes comparisons among various state databases (sometimes even including those of cooperating neighbor states) to find discrepancies and select returns for audit.

For instance, South Carolina expects to capture an extra $100 million in taxes over five years by using motor vehicle records to discover nonfilers for the state personal income tax. Texas finds business nonfilers by using property ownership records, and Massachusetts compares the database of income tax filers with those who remit sales/use taxes and the tax on restaurant meals. Another sales/use tax inquiry uses U.S. Customs records to determine whether the state tax was paid when the resident returned from overseas with property.

Other states have seen these successes and are exploring their own applications of data mining. As one might expect, several consulting firms have emerged to provide software and strategies to states, whose internal data processing capabilities are insufficient to produce the tax collections desired in today's budgetary situation.

Three-factor apportionment was designed for an age of traveling sales representatives and sales of built, grown, and manufactured goods. Sales reps were assigned territories that they could drive through on short notice, so they usually lived close to their customer base. In that case, the sales and payroll factors could be highly redundant. Today, with communication and distribution systems more highly developed, the sales factor appears incrementally to be the preferred income-sourcing device. Sales of goods and services should be assigned based on a destination test so that the transaction is assigned to the state of the purchaser.

The three-factor formula further breaks down for income derived from specialized industries, as evidenced by the special computational methods allowed by many states. Perhaps the economy is so specialized today that income simply cannot be assigned by the use of one simple formula. Nonetheless, more uniformity among the states as to definitions and computational rules for the factors would be welcome.

The U.S. Treasury has held hearings in the last decade concerning the adoption of an apportionment approach to the sourcing of international taxable income. Although a formulary apportionment would represent a more reliable and predictable method of dividing multinational income and deduction amounts, the data collection burden that such a system would create may be too much to expect from most of the trading partners in the short term. Moreover, the model treaties developed by the United States and the Organization for Economic Cooperation and Development (OECD) include language relating to the income-sourcing rules and transfer pricing at arm's length, not an apportionment approach.

TRANSFER PRICING

The transfer pricing system used in international trade requires the taxpayer to keep a database of comparable prices and transactions, even though often no such comparability exists. Especially when dealing with proprietary goods and design, it may be impossible to find comparable goods and, therefore, an acceptable transfer price for them. One solution to this situation would be to allow additional definitions of comparable goods, or of ranges of acceptable transfer prices, perhaps subjected to audit on a rotating five-year basis. The use of advance pricing

TAX in the NEWS

States in a Bind on Sales/Use Tax on Internet Sales

In the mid-1960s, the Supreme Court held in *National Bellas Hess* that the seller had no sales/use tax nexus with a state into which a sale was made using catalogs and other general advertising materials. In the early 1990s, the Court's decision in *Quill* extended this no-nexus holding to 800 telephone numbers and Internet sales. As a result, states find it difficult to collect taxes on remote sales of personal property, electronic goods and software downloads, and services that clearly are taxable under existing law.

This issue addresses who should collect the tax, not whether a tax is due, or the amount of the liability. Existing law allows the states to collect a tax, but they have found it impossible to chase down all the Internet sellers around the world who deal with local residents, get them to register for the sales/use tax, and remit the tax liability due. Aware of this difficulty, many sellers today still charge no use tax on out-of-state transactions, with little to fear from understaffed state and local tax audit staffs. Correcting this problem does not constitute a tax increase, but it does require a new approach to enforcement and collection.

The stakes are extremely high, as Internet sales annually exceed $400 billion. This situation is not just a battle between the "bricks" and "clicks" economies—it is a problem in which we all share as taxpayers and recipients of government goods and services.

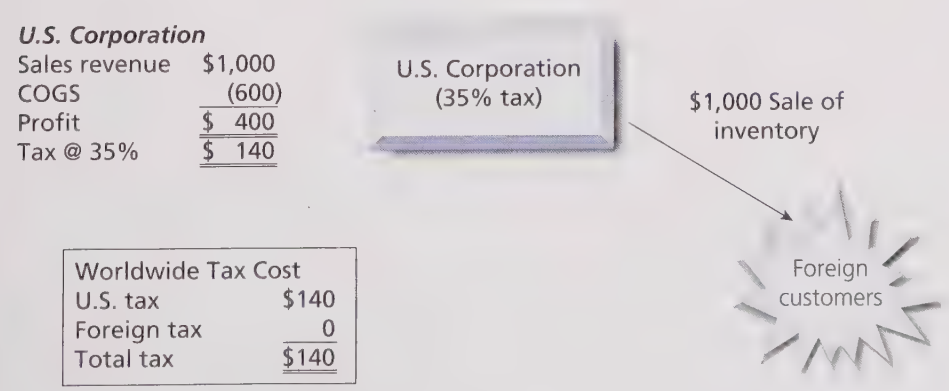
The court battles that will follow any state that forces sellers to start collecting use tax on its cross-border Internet sales are "worth it" in terms of the future revenues that any victory would bring. The counterargument that appearing to increase taxes on e-commerce will hurt business and economic development forces a political dispute. Should a politician come down on the side of $200 million per year in new Internet sales tax collections or a $200 million cut in public health care for lower-income citizens?

agreements further allows a greater degree of control by the governments in data collection and analysis, ideally prior to the undertaking of the sales or manufacturing transactions.

EXAMPLE 26

Consider the transaction depicted in the diagram below. A U.S. corporation manufactures and sells inventory to an unrelated foreign customer. The sales price for the inventory is $1,000 and the related cost of goods sold (COGS) is $600. The resulting profit of $400 all is taxed to the U.S. corporation, resulting in a $140 U.S. income tax liability ($400 × 35%). If the U.S. corporation has no business presence in the foreign jurisdiction and merely is selling to a customer located there, the foreign government is unlikely to impose any local income tax on the U.S. corporation. Consequently, the total tax burden imposed on the inventory sale is $140.

Sale without Using Related Party



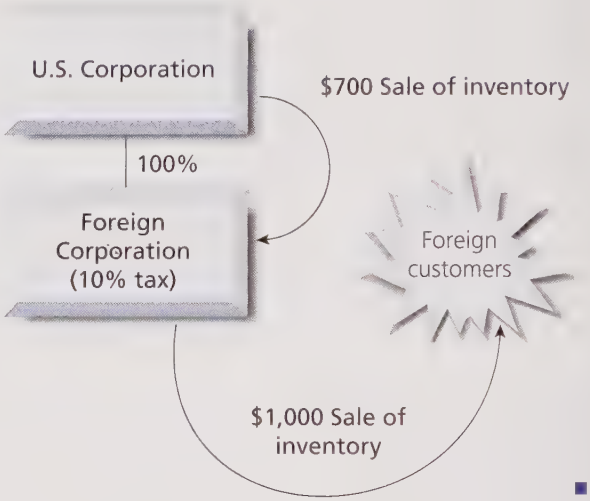
Suppose instead that the U.S. corporation attempts to reduce its total tax expense by channeling the inventory sale through a foreign subsidiary in the same country as the foreign customer. In this case, because the U.S. corporation controls the foreign subsidiary, it chooses an intercompany sales price (the transfer price) that moves a portion of the profits from the United States to the foreign country. By selling the inventory it manufactured to its 100%-owned foreign subsidiary for $700, the U.S. corporation reports only $100 of profits and an associated U.S. tax liability of $35. The foreign subsidiary then sells the inventory to the ultimate customer for $1,000, and, with a $700 COGS, it earns a $300 profit. Now, the foreign country imposes only a 10% tax on corporate profits, resulting in a foreign income tax of $30($300 × 10%). By using a related foreign entity in a lower-tax jurisdiction, the U.S. corporation has lowered its overall tax liability on the sale from $140 (all U.S.) to $65 ($35 U.S. and $30 foreign).

Sale Using Related Party

U.S. Corporation	
Sales revenue	$700
COGS	(600)
Profit	$100
Tax @ 35%	$ 35

Foreign Corporation	
Sales revenue	$1,000
COGS	(700)
Profit	$ 300
Tax @ 10%	$ 30

Worldwide Tax Cost	
U.S. tax	$35
Foreign tax	30
Total tax	$65



The critical question is whether the IRS views the $700 intercompany sales price of Example 26 as the appropriate transfer price. Under § 482, the IRS may question why the foreign corporation deserved to earn $300 of the total $400 profit related to the manufacture and sale of the inventory. In general, the U.S. corporation must document the functions performed by the foreign corporation, the assets it owns that assist in producing the income, or the risks it takes (e.g., credit risk). Without documentation of significant functions, assets, or risks of the foreign subsidiary, the IRS will not consider the $300 profit earned by the foreign corporation to be appropriate, and it will adjust the transfer price upward. If the IRS determines that the



Bridge to Cost Accounting and Executive Compensation

Multijurisdictional companies operate across state and country borders. As illustrated, the transfer price used by a company can have a significant effect on the amount of profits subject to taxation within a particular taxing jurisdiction. Companies face other concerns when establishing transfer pricing policies. For example, the internal determination of how a division of the company is performing may be based on transfer pricing between related entities within the global group. Furthermore, the compensation of the managers within those divisions may be tied directly to divisional performance.

If an intercompany price is set in a manner that optimizes the global tax position, a separate cost accounting policy may be required to determine an entity's profitability for purposes of compensating employees. Tax advisers often face resistance from operations managers when suggesting improved transfer pricing methods, because such improvements often change the traditional division of profits among different parts of the business.

TAX in the NEWS

A Move to the Beach for U.S. Corporations Seeking a Vacation from U.S. Tax Rules

A number of U.S.-based companies decided to cast their lot on the golden shores of Bermuda, reincorporating as Bermuda companies and enjoying Bermuda's low-tax environment. Examples include such well-known companies as Fruit of the Loom, Cooper Industries, Foster Wheeler, and Ingersoll Rand. Even Accenture, formerly Andersen Consulting, established itself in Bermuda. Many of these companies argue that U.S. international tax policy compromises their ability to compete in the global marketplace. The stock market often rewarded these so-called inversion transactions (i.e., conversion from U.S. to foreign based) with increased stock prices.

Although an inversion transaction often entailed a current tax cost, the long-term tax benefits were considered more important. For example, with a Bermuda parent company rather than a U.S. parent company, many of the lower-tier foreign subsidiaries would not constitute CFCs. Many other companies were preparing to invert when Congress developed anti-inversion rules, and the public began reacting negatively to these corporate expatriates. Toolmaker Stanley Works called off its previously announced, and very controversial, inversion plans, and subsequent years saw very few inversions of U.S. companies.

transfer price should have been $990, then the U.S. corporation reports a $390 profit (with $136.50 U.S. income tax), and the foreign corporation earns a $10 profit (with $1 in foreign income tax). With this change in transfer price, the U.S. corporation does not succeed in transferring a meaningful portion of its profits to the lower-tax jurisdiction and reduces its tax liability by only $2.50.

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.



TAX

The OECD's Tax Haven Blacklist

In 2000, the OECD identified these jurisdictions as tax havens that had not cooperated with its campaign to stop harmful global tax practices. As of 2009, none of the countries remained on the list.

Andorra
Anguilla
Antigua and Barbuda
Aruba
Bahamas
Bahrain
Barbados
Belize
British Virgin Islands
Cook Island
Dominica
Gibraltar
Grenada
Guernsey
Isle of Man
Jersey
Liberia
Liechtenstein
Maldives
Marshall Islands
Monaco
Montserrat
Nauru
Netherlands Antilles
Niue
Panama
Samoa
Seychelles
St. Christopher and Nevis
St. Lucia
St. Vincent and the Grenadines
Tonga
Turks and Caicos Islands
U.S. Virgin Islands
Vanuatu

Sources: Organization for Economic Cooperation and Development (OECD), *Towards Global Tax Cooperation: Progress in Identifying and Eliminating Harmful Tax Practices*, 2000; OECD News Release, July 8, 2007; OECD's *Project on Harmful Tax Practices: The 2006 Progress Report*, 2006; and **www.oecd.org/dataoecd/50/0/43606256.pdf**.

TAX HAVENS

When taxpayers perceive effective tax rates as too high, planning usually includes seeking out a tax haven. If income-producing securities or profitable service operations can be moved to another jurisdiction, ideally one with significantly lower marginal tax rates on that type of income, permanent tax savings can be achieved.

When a government witnesses a loss of its tax base due to the transfer of assets and income out of the jurisdiction, anti-tax-haven legislation becomes attractive. The U.S. international tax regime shows several distinct attempts to find and tax income moved offshore, but those taxes collect few dollars in the typical tax year. The investment holding company structure currently used by multistate taxpayers has been met with little effective restrictive legislation from the states, probably out of fear of being branded "anti-business."

Perhaps a separate set of nexus rules could be created to address the most portable types of income, such as that from interest and dividends. But this difficult problem likely needs a multilateral solution, which is unlikely to be found in the short term among states and countries, each with unique revenue shortfalls and political profiles.

Tax Planning Strategies HOLDING COMPANIES MAKE OTHER STATES ANGRY

FRAMEWORK FOCUS: TAX RATE

Strategy: Shift Net Income from High-Tax Jurisdictions to Low-Tax Jurisdictions.

A tax dollar saved in one state is a tax dollar lost in another. That's how some state tax administrators and observers view the use of the **passive investment holding company**. A spokesman for the Multistate Tax Commission asserts that the average state income tax rate paid by larger conglomerates has fallen from about 9.6 percent in 1980 to about 5.2 percent today. And the Secretary of Revenue in North Carolina says it's not fair that corporate tax savings must be recovered from income and sales/use taxes on individuals.

The Delaware version of the investment holding company is the great offender being blamed here. By isolating intangible assets like trademarks, and investment assets generating income, in tax-friendly states like Delaware, corporate giants can achieve major tax reductions.

These savings may not be easily obtained for long, however. State tax authorities have worked hard to target the holding companies operated by such familiar names as Home Depot, Staples, The Gap and The Limited, and Burger King. Tax advisers tell their clients to comply with the tax laws, but they also devise strategies to use holding companies and other "nowhere income" devices. Passive investment companies seem to be the target of serious attacks by the states, thereby reducing their effectiveness.

INTERJURISDICTIONAL AGREEMENTS

Treaties are documents that address many issues other than the taxable income computation. They involve several players within the governmental structure, and they take several years to draft and adopt. Treaties involving the United States tend to be only bilateral, meaning that it is difficult to anticipate and coordinate the interaction of several treaties as they apply to a single taxpayer.

At the multistate level, the Federal government has been slow to take up issues involving a synchronization of the income tax systems used by the states. Although this reluctance may be partly for strictly constitutional reasons, it is largely because of the difficulties presented by the lack of uniformity among the states' tax laws and enforcement efforts.

But the future must hold a greater degree of cooperation among various taxing jurisdictions, at least in the trading of information and the coordination of enforcement efforts. The United States must create additional treaties or information-sharing agreements with countries in South America and Africa. And the future of the

European Union probably holds a series of highly developed agreements addressing tax issues with the United States.

Procedural developments may accomplish the same result. For instance, block filing by S corporations and their shareholders with various states accomplishes a number of income division and information-sharing goals. Applying the same approach to partnerships and limited liability entities, and perhaps C corporations with a small number of shareholders, would be an important step forward. Including the multinational activities of such flow-through and closely held entities would also allow for a more coordinated result. Sharing data, while still respecting the confidentiality needs of the taxpayer and requirements of the governments, represents a technologically sound method of collecting taxes in today's multijurisdictional economy.

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.



REFOCUS ON THE BIG PICTURE

GOING INTERNATIONAL

Simply selling into a foreign jurisdiction probably will not trigger any overseas income tax consequences. However, income earned from foreign sales is taxed currently to VoiceCo in the United States. When VoiceCo establishes a CFC in Ireland, it benefits from deferral. As long as the income is not distributed to VoiceCo and as long as the income is not "tainted" Subpart F income, VoiceCo can avoid taxes on the profits of VoiceCo-Ireland. If VoiceCo receives dividends from its foreign subsidiary, it can claim foreign tax credits, which help alleviate the double taxation that would otherwise result.

What If?

VoiceCo is considering building a new manufacturing facility in another state in the United States. How will VoiceCo's expansion decision be affected by state tax considerations? In making the decision to expand, VoiceCo should consider a variety of state tax issues including whether the state imposes a corporate income tax at all and, if so, whether the state requires unitary reporting. Other relevant issues affecting the tax calculation in the state include the apportionment formula used by the state and whether the state has a throwback rule.

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KEY TERMS

Allocate, 13–25
Apportioned, 13–25
Arm's length price, 13–17
Check-the-box, 13–18
Controlled foreign corporations (CFCs), 13–14
Deemed-paid credit, 13–11
Effectively connected income, 13–19
FDAP, 13–20
Foreign tax credit, 13–7
Inbound taxation, 13–4
Income tax treaties, 13–4
Multistate Tax Commission (MTC), 13–22
Nexus, 13–23
Nonresident alien (NRA), 13–19
Outbound taxation, 13–4
Passive investment holding company, 13–34
Payroll factor, 13–26
Permanent establishment (PE), 13–5
Property factor, 13–26
Public Law 86–272, 13–22
Sales factor, 13–26
Separate foreign tax credit limitation categories, 13–13
Solicitation, 13–22
Subpart F income, 13–14
Throwback rule, 13–27
Unitary approach, 13–28
U.S. shareholder, 13–15
Waters'-edge election, 13–28

PROBLEMS

1. **LO.1** What is the meaning of the statement "U.S. persons are taxed on their worldwide income"?

2. **LO.1** Liang, a U.S. citizen, owns 100% of ForCo, a foreign corporation not engaged in a U.S. trade or business. Absent any dividends or Subpart F inclusions, is Liang subject to any U.S. income tax on the profits of ForCo?

3. **LO.3** BlueCo, a domestic corporation, incorporates GreenCo, a new wholly owned entity in Germany. Under both German and U.S. legal principles, this entity is a corporation. Assume that BlueCo faces a 35% U.S. tax rate. GreenCo earns $500,000 in net profits from its German activities, and GreenCo makes no dividend distributions to BlueCo. How much U.S. tax will BlueCo pay for the current year as a result of GreenCo's earnings, assuming that there is no deemed dividend under Subpart F? Ignore any foreign tax credit (FTC) implications.

4. **LO.3** Evaluate this statement: It is unfair that the United States taxes its citizens and residents on their worldwide income.

5. **LO.2** Explain why an income tax treaty between the United States and Germany can be very favorable to a U.S. person who earns investment or business income from Germany.

6. **LO.3** Describe the different approaches used by countries to tax the earnings of their citizens and residents generated outside the borders of the country.

7. **LO.3** Determine the source (U.S. or foreign) of the following items of income.
   a. Interest income paid by a foreign corporation.
   b. Dividend income paid by a U.S. corporation that has no foreign operations.
   c. Dividend income paid by a foreign corporation that has U.S. operations that historically produce 32% of the corporation's income.
   d. Income from providing consulting services to clients with 27% of the services provided to clients on-site in Mexico.

DECISION MAKING

8. **LO.3** Ocean, Inc., produces inventory in its foreign manufacturing plants for sale in the United States. Its foreign manufacturing assets have a tax book value of $7 million and a fair market value of $15 million. Its assets related to the sales activity have a tax book value of $600,000 and a fair market value of $200,000. Ocean's interest expense totaled $80,000 for the current year.
   a. What amount of interest expense is allocated and apportioned to foreign-source income using the tax book value method? What amount of Ocean's interest expense is allocated and apportioned to foreign-source income using the fair market value method?
   b. If Ocean wishes to maximize its FTC, which method should it use?

9. **LO.3** USCo, a domestic corporation, purchases inventory for resale from distributors within the United States and resells this inventory to customers outside the United States, with title passing outside the United States. What is the source of USCo's inventory sales income?

10. **LO.3** USCo, a domestic corporation, owns the rights to a patent related to a medical device. USCo licenses the rights to use the patent to IrishCo, a foreign corporation. IrishCo uses the patent in a manufacturing facility located in Ireland. What is the source of the royalty income received by USCo from IrishCo for the use of the patent?

11. **LO.3** USCo incurred $100,000 in interest expense for the current year. The tax book value of USCo's assets generating foreign-source income is $5 million. The tax book value of USCo's assets generating U.S.-source income is $95 million. How much of the $100,000 interest expense is allocated and apportioned to foreign-source income?

12. **LO.3** What is the purpose of the foreign tax credit limitation?

13. **LO.3** USCo, a domestic corporation, receives a $10,000 dividend from ForCo, a wholly owned foreign corporation. The deemed-paid (indirect) foreign tax credit associated with this dividend is $3,000. What is the total gross income included in USCo's tax return as a result of this dividend?

14. **LO.3** Explain why a U.S. taxpayer must recapture an overall foreign loss in calculating the foreign tax credit limitation.

15. **LO.3** ABC, Inc., a domestic corporation, has $40 million of taxable income, including $12 million of general limitation foreign-source taxable income, on which ABC paid $4.8 million in foreign income taxes. The U.S. tax rate is 35%. What is ABC's foreign tax credit?

16. **LO.3** Mary, a U.S. citizen, is the sole shareholder of CanCo, a Canadian corporation. During its first year of operations, CanCo earns $14 million of foreign-source taxable income, pays $6 million of Canadian income taxes, and distributes a $2 million dividend to Mary. Can Mary claim a deemed-paid (indirect) foreign tax credit on her Form 1040 with respect to receipt of a dividend distribution from CanCo?

17. **LO.3** ABC, Inc., a domestic corporation, owns 100% of HighTax, a foreign corporation. HighTax has $50 million of post-1986 undistributed earnings, all of which is attributable to general limitation income, and $50 million of post-1986 foreign income taxes. HighTax distributes a $5 million dividend to ABC. The dividend, which is subject to a 5% foreign withholding tax, is ABC's only item of income during the year. The U.S. tax rate is 35%. What amount of excess foreign tax credits is produced by the dividend?

18. **LO.3** USCo, a domestic corporation, reports worldwide taxable income of $1,500,000, including a $300,000 dividend from ForCo, a wholly owned foreign corporation. ForCo's post-1986 undistributed earnings and profits total $16 million, and it has paid $10 million of foreign income taxes attributable to these earnings. All foreign income is in the general limitation basket. What is USCo's deemed-paid (indirect) foreign tax credit related to the dividend received (before consideration of any limitation)?

19. **LO.3** USCo, a domestic corporation, reports worldwide taxable income of $500,000, including a $100,000 dividend from ForCo, a wholly owned foreign corporation. ForCo's post-1986 undistributed earnings and profits total $1 million, and it has paid $200,000 of foreign income taxes attributable to these earnings. All foreign income is in the general limitation basket. What is USCo's deemed-paid (indirect) foreign tax credit related to the dividend received (before consideration of any limitation)?

20. **LO.3** Fleming, Inc., a domestic corporation, operates in both Canada and the United States. This year, the business generated taxable income of $400,000 from foreign sources and $300,000 from U.S. sources. All of Fleming's foreign-source income is in the general limitation basket. Fleming's total worldwide taxable income is $700,000. Fleming pays Canadian taxes of $152,000. What is Fleming's allowed FTC for the tax year? Assume a 35% U.S. income tax rate.

21. **LO.3** Drake, Inc., a U.S. corporation, operates a branch sales office in Turkey. During the current year, Drake earned $500,000 in taxable income from U.S. sources and $100,000 in taxable income from sources within Turkey. Drake paid $40,000 in income taxes to Turkey.

All the income is characterized as general limitation income. Compute Drake's U.S. income tax liability after consideration of any foreign tax credit. Drake's U.S. tax rate is 35%.

22. **LO.3** Crank, Inc., a U.S. corporation, operates a branch sales office in Ghana. During the current year, Crank earned $200,000 in taxable income from U.S. sources and $50,000 in taxable income from sources within Ghana. Crank paid $5,000 in income taxes to Ghana. All the income is characterized as general limitation income. Compute Crank's U.S. income tax liability after consideration of any foreign tax credit. Crank's U.S. tax rate is 35%.

23. **LO.3** Harold, Inc., a domestic corporation, earned $500,000 from foreign manufacturing activities on which it paid $150,000 of foreign income taxes. Harold's foreign sales income is taxed at a 45% foreign tax rate. Both sales and manufacturing income are assigned to the general limitation basket. What amount of foreign sales income can Harold earn without generating any excess FTCs for the current year? Assume a 35% U.S. rate.

24. **LO.3** Food, Inc., a domestic corporation, owns 70% of the stock of Drink, Inc., a foreign corporation. For the current year, Food receives a dividend of $20,000 from Drink. Drink's post-1986 E & P (after taxes) and foreign taxes are $6 million and $800,000, respectively. What is Food's total gross income from receipt of this dividend if it elects to claim the FTC for deemed-paid foreign taxes?

25. **LO.3** Orion, Inc., a U.S. corporation, has foreign-source income and pays foreign taxes for the tax year as follows.

	Income	Taxes
Passive category	$150,000	$ 13,000
General category	300,000	150,000

Orion's worldwide taxable income is $600,000, and U.S. taxes before the FTC are $210,000 (assume a 35% rate). What is Orion's U.S. tax liability after the FTC?

ISSUE ID

26. **LO.3** Discuss the policy reasons for the existence of the Subpart F rules. Give two examples of Subpart F income.

27. **LO.3** USCo owns 55% of the voting stock of LandCo, a Country X corporation. IrishCo, an unrelated Country Y corporation, owns the other 45% of LandCo. LandCo owns 100% of the voting stock of OceanCo, a Country Z corporation. Assuming that USCo is a U.S. shareholder, do LandCo and OceanCo meet the definition of a CFC?

28. **LO.3** Is a foreign corporation owned equally by 100 unrelated U.S. citizens considered a controlled foreign corporation?

29. **LO.3** Snowball Enterprises, a domestic corporation, owns 100% of Aussie, Ltd., an Australian corporation. Determine whether any of the following transactions produce Subpart F gross income for the current year.

- Aussie earned $300,000 from sales of products purchased from Snowball and sold to customers outside Australia.
- Aussie earned $500,000 from sales of products purchased from Snowball and sold to customers in Australia.
- Aussie earned $200,000 from sales of products purchased from unrelated suppliers and sold to customers in Ireland.
- Aussie purchased raw materials from Snowball, used these materials to manufacture finished goods, and sold these goods to customers in New Zealand. Aussie earned $100,000 from these sales.
- Aussie earned $60,000 for the performance of warranty services on behalf of Snowball. These services were performed in Japan for customers located in Japan.
- Aussie earned $30,000 in dividend income from passive investments.

30. **LO.3** Ames, Inc., a U.S. corporation, owns 100% of Boone, Ltd., a United Kingdom corporation. Boone purchases finished inventory from Ames and sells the inventory to customers in the U.K. and Germany. During the current year, Ames earned $600,000 in profits from sales to U.K. customers and $400,000 in profits from sales to German

customers. Boone operates a sales office in London with 12 full-time employees. How much of Boone's $1 million in profits will be characterized as Subpart F income?

31. **LO.4** Explain the purpose of determining whether a foreign person is engaged in a U.S. trade or business.

32. **LO.4** Evaluate the following statement: Foreign persons are never subject to U.S. taxation on U.S.-source investment income so long as they are not engaged in a U.S. trade or business.

33. **LO.3** Lili, Inc., a domestic corporation, operates a branch in France. The earnings record of the branch is as follows. CRITICAL THINKING

Year	Taxable Income (Loss)	Foreign Taxes Paid
2008	($ 25,000)	$ –0–
2009	(40,000)	–0–
2010	(10,000)	–0–
2011	120,000	40,000

For 2008–2011, Lili, Inc., has U.S.-source taxable income of $500,000 each year. What is the allowed FTC for 2011? Assume a 35% U.S. tax rate.

34. **LO.3, 4** Write a short memo on the difference between "inbound" and "outbound" activities in the context of U.S. taxation of international income. COMMUNICATIONS

35. **LO.3** Hillman, Inc., a U.S. corporation, owns 100% of NewGrass, Ltd., a foreign corporation. NewGrass earns only general limitation income. During the current year, NewGrass paid Hillman a $10,000 dividend. The § 902 credit associated with this dividend is $4,000. The foreign jurisdiction requires a withholding tax of 20%, so Hillman received only $8,000 in cash as a result of the dividend. What is Hillman's total U.S. gross income reported as a result of the $8,000 cash dividend?

36. **LO.4** ForCo, a foreign corporation not engaged in a U.S. trade or business, received a $500,000 dividend from USCo, a domestic corporation. ForCo incurred $20,000 in expenses related to earning the dividend. USCo's income is all from U.S. sources. ForCo is not eligible for any treaty benefits. What is the withholding tax on the dividend paid to ForCo?

37. **LO.5** Evaluate this statement: A state can tax only its resident individuals and the corporations and partnerships that are organized in-state.

38. **LO.5** What is the function of the Multistate Tax Commission? Why have some U.S. states not joined the MTC?

39. **LO.5** You are working with the top management of one of your clients in selecting the U.S. location for a new manufacturing operation. Craft a plan for the CEO to use in discussions with the economic development representatives of each of the top candidate states. In no more than two PowerPoint slides, list some of the tax incentives the CEO should request from a particular state during the bilateral negotiations between the parties. Your list should be both creative and aggressive in its requests. ISSUE ID COMMUNICATIONS

40. **LO.5** Considering only the aggregate state income tax liability, how should a taxpayer, resident in State A and selling widgets, deploy its sales force? The states that entail the taxpayer's entire customer base use the following flat income tax rates. DECISION MAKING

State A	5%
State B	3
State C	6
State D	0

41. **LO.5** Continue to consider the case of the taxpayer in Problem 40. Is it acceptable to you if the taxpayer purposely shifts its sales force among the states so as to reduce its tax liabilities? ETHICS AND EQUITY

42. **LO.6** Compute state taxable income for HippCo, Inc. Its Federal taxable income for the year is $1 million. Its operations are confined to Oregon and Montana. HippCo generates only business and interest income for the year.

    - Federal cost recovery deductions totaled $200,000. Montana used this amount, but Oregon allowed only $120,000.
    - Interest income of $25,000 from Oregon bonds was excluded from Federal taxable income. Oregon taxes all municipal bond income, while Montana taxes all such interest except that from its own bonds.
    - Interest income from Treasury bonds that was recognized on the Federal return came to $11,000. Neither state taxes such income.

43. **LO.6** Continue with the facts of Problem 42. Using the format of Figure 13.2, compute state taxable income for HippCo, assuming also that the taxpayer recognized $225,000 of net rent income during the year from a warehouse building in Montana. Federal taxable income still is $1 million.

44. **LO.6** PinkCo, Inc., operates in two states. It reports the following results for the year. Compute the apportionment percentage for both states. Amounts are stated in millions of dollars.

	State A	State B	Totals
Sales	$25	$ 75	$100
Payroll	20	30	50
Property	0	100	100

45. **LO.6** Repeat the computations of Problem 44, but now assume that State B uses a double-weighted sales factor in its apportionment formula.

46. **LO.6** Repeat the computations of Problem 44, but now assume that State A is a sales-factor-only state and that State B uses the following weights: sales .70, payroll .15, and property .15.

ISSUE ID

47. **LO.6** State A enjoys a prosperous economy, with high real estate values and compensation levels. State B's economy has seen better days—property values are depressed, and unemployment is higher than in other states. Most consumer goods are priced at about 10% less in B as compared to prices in A. Both A and B apply unitary income taxation on businesses that operate in-state. Does unitary taxation distort the assignment of taxable income between A and B? Explain.

48. **LO.7** Diagram the creation of an investment subsidiary in Delaware, by Parent, a Massachusetts corporation conducting all of its current sales activities through a single subsidiary, Junior, Inc.

CRITICAL THINKING

49. **LO.6** Determine for your state and two of its neighbors:
    a. Whether a Federal affiliated group is allowed to file a consolidated return with the state.
    b. What the return is called (i.e., a "combined," "consolidated," or other type of return).
    c. Whether any special rules apply to the use of consolidated returns in the state (e.g., a special election is required, a limitation on deductible losses applies, a specified term exists during which the election to consolidate is binding).

CRITICAL THINKING

COMMUNICATIONS

50. **LO.6** Hernandez, which has been an S corporation since inception, is subject to tax in States Y and Z. On Schedule K of its Federal Form 1120S, Hernandez reported ordinary income of $500,000 from its business, taxable interest income of $10,000, capital loss of $30,000, and $40,000 of dividend income from a corporation in which it owns 30%.

    Both states apportion income by use of a three-factor formula that equally weights sales, payroll, and the average cost of property; both states treat interest and dividends as business income. In addition, both Y and Z follow Federal provisions with respect to the determination of taxable income for a corporation. Y recognizes S status, but Z does not. Based on the following information, write a memo to the shareholders of Hernandez, detailing the amount of taxable income on which Hernandez will pay tax in Y and Z. Hernandez corporate offices are located at 5678 Alabaster Circle, Koopville, KY 47697.

	State Y	State Z
Sales	$1,000,000	$800,000
Property (average cost)	500,000	100,000
Payroll	800,000	200,000

51. **LO.6, 7** As the director of the multistate tax planning department of a consulting firm, you are developing a brochure to highlight the services it can provide. Part of the brochure is a list of five or so key techniques that clients can use to reduce state income tax liabilities. Develop this list for the brochure and send it to your instructor as two PowerPoint slides.

COMMUNICATIONS

52. **LO.3, 7** Miha Ohua is the CFO of a U.S. company that has operations in Europe and Asia. The company has several manufacturing subsidiaries in low-tax foreign countries where the tax rate averages 6%. These subsidiaries purchase raw materials used in the production process from related subsidiaries located in countries where the tax rate averages 33%.

Miha is considering establishing a transfer price for the raw materials so that the higher-tax subsidiaries charge a low price for the raw materials. In this way, little of the profit is left in these subsidiaries, and most of the profits end up in the low-tax subsidiaries. This approach might reduce the U.S. company's overall global tax rate. Write a memo to Miha outlining the issues with this plan.

ISSUE ID

Bridge DISCIPLINE

1. What type of information-sharing agreements does the IRS have with the revenue agency of the Bahamas? Canada? Germany? Israel? Argentina?
2. Write a paper of no more than two pages, discussing the treatment of state and local taxes that is found in the text of U.S. income tax treaties with two other countries.

COMMUNICATIONS

3. Several U.S. states finance their operations without the benefit of a corporate income tax. Prepare five to seven PowerPoint slides and make a presentation to your school's Accounting Club. In your presentation, discuss the public economic and policy effects of using nontraditional revenue sources to fund state operating and infrastructure projects. Compare the taxing and expenditure process used in your state with at least two of these states: Alaska, Hawaii, Michigan, Texas, Washington D.C., Washington State.

COMMUNICATIONS

RESEARCH PROBLEMS

Use the tax resources of the Internet to address the following questions. Do not restrict your search to the Web, but include a review of newsgroups and general reference materials, practitioner sites and resources, primary sources of the tax law, chat rooms and discussion groups, and other opportunities.

INTERNET *activity*

Research Problem 1. Review the last six months' archive of articles in one of the newspapers that you read. Use search terms such as "expatriate" and "tax haven" to look for articles that examine the ability of a taxpayer to move U.S. income offshore. Summarize two of the articles in an e-mail sent to your instructor.

COMMUNICATIONS

Research Problem 2. Make a list of the countries with which the United States currently has an income tax treaty. Then make a list of the countries with which the United States currently is negotiating an income tax treaty. For the second list, include the date on which negotiations started and the current status of the negotiations.

Research Problem 3. Locate the most recent financial statements of four different publicly traded U.S. companies. Examine their tax footnotes and determine (1) the percentage of total income before taxes earned from foreign sources, (2) the overall effective tax rate, and (3) the effect, if any, on the effective tax rate of earning income outside the United States. Summarize this information in an e-mail to your instructor.

COMMUNICATIONS

Research Problem 4. Shane, plc, is a corporation created and organized in France. All of Shane's owners are French citizens and residents. Most of Shane's income is derived from active business operations within France. During the current year, Shane invested excess cash into bonds issued by a U.S. corporation. Under Article 11 of the U.S.-French tax treaty, the interest income from the bonds is exempt from withholding. The U.S. corporation has requested that Shane complete a Form W-8BEN to document this treatment. Shane's address is 25 Rue Blomet, Paris, France, 75015. Visit the IRS website, locate a Form W-8BEN, complete Shane's form online using the "fill in" function of the IRS form, and print the completed form.

COMMUNICATIONS

Research Problem 5. Locate data on the size of the international economy, including data on international trade, foreign direct investment of U.S. firms, investments in the United States by foreign firms, etc. Useful web locations include **www.census.gov** and **www.bea.gov**. Prepare an analysis of these data for a three-year period using spreadsheet and graphing software, and e-mail your findings to your instructor.

Research Problem 6. Determine which, if any, of the multistate information-sharing groups your state has joined, as to either income or sales/use tax transactions.

COMMUNICATIONS

Research Problem 7. For your state and one of its neighbors, determine the following. Place your data in a chart and e-mail it to your professor.

a. To what extent do the states follow the rulings of the Multistate Tax Commission?
b. What is each state's apportionment formula, with factors and weightings?
c. Does the state adopt pertinent changes to the Internal Revenue Code? As of what date?

COMMUNICATIONS

Research Problem 8. Read the "tax footnote" of five publicly traded U.S. corporations. Find the effective state/local income tax rates of each. Create a PowerPoint presentation (maximum of five slides) for your instructor, summarizing the search and reporting the findings.

COMMUNICATIONS

Research Problem 9. Use **taxsites.com** or some other index to find a state/local tax organization (e.g., the Council on State Taxation). Read its current newsletter. In an e-mail to your instructor, summarize a major article at the site. Look especially for articles on one of these topics.

- Application of nexus rules to tax profits from intangible assets.
- Application of gross receipts taxes on S corporations, partnerships, and LLCs by your home state.
- Limitations on the taxpayer's ability to carry back net operating losses in computing your state's corporate taxable income.
- Responses to the economic downturn, e.g., more aggressive enforcement, new taxes and fees, installment options for the late payment of taxes and penalties.
- Incidence of state/local tax payments, i.e., how much of the total tax collections is paid by individuals, corporations, out-of state businesses.

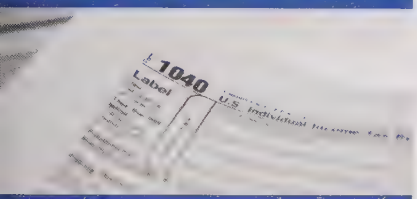
COMMUNICATIONS

Research Problem 10. For your state and one of its neighbors, summarize in a table three of the tax incentives for business that are offered through the income, sales, or property tax structure. For instance, many states offer a tax credit for expenditures made in-state for new business equipment. In your table, list at least the following. E-mail your table to the others in your course.

- Name of the credit, deduction, exemption, etc.
- Who qualifies for the incentive (e.g., corporations, individuals, partnerships).
- Computational base for the incentive (e.g., dollars spent).
- Rate of the credit or deduction.
- Minimums, maximums, and other limitations that apply to the incentive amount.

CHAPTER 14

Business Tax Credits and Corporate Alternative Minimum Tax



TAX *Talk*

A government which robs Peter to pay Paul can always count on the support of Paul.

—GEORGE BERNARD SHAW

LEARNING OBJECTIVES

After completing Chapter 14, you should be able to:

LO.1 Explain **how tax credits are used as a tool of Federal tax policy.** **(pp. 14-2 to 14-3)**

LO.2 Work with various **business-related tax credits.** **(pp. 14-3 to 14-13)**

LO.3 Explain the **reason for the alternative minimum tax.** **(pp. 14-13 to 14-16)**

LO.4 Identify and calculate the **tax preferences** that are included in determining the AMT. **(pp. 14-16 to 14-18)**

LO.5 Identify and calculate **AMT adjustments.** **(pp. 14-18 to 14-24)**

LO.6 Understand the function of **adjusted current earnings** (ACE). **(pp. 14-25 to 14-27)**

LO.7 Compute the **AMT liability for corporations.** **(pp. 14-27 to 14-30)**

OUTLINE

14.1 Tax Policy and Tax Credits, 14-2
14.2 Specific Business-Related Tax Credit Provisions, 14-3
General Business Credit, 14-3
Tax Credit for Rehabilitation Expenditures, 14-5
Work Opportunity Tax Credit, 14-7
Research Activities Credit, 14-8
Energy Credits, 14-10
Disabled Access Credit, 14-10
Credit for Small Employer Pension Plan Startup Costs, 14-11
Credit for Employer-Provided Child Care, 14-11
Foreign Tax Credit, 14-12
14.3 Corporate Alternative Minimum Tax, 14-13
The AMT Formula, 14-15
Tax Preferences, 14-16
AMT Adjustments, 14-18
Adjusted Current Earnings (ACE), 14-25
Computing Alternative Minimum Taxable Income, 14-27
AMT Rate and Exemption, 14-28
Minimum Tax Credit, 14-28
Other Aspects of the AMT, 14-29
14.4 Individual Alternative Minimum Tax, 14-29

THE BIG PICTURE Tax Solutions for the Real World

DEALING WITH TAX CREDITS AND THE AMT

Mike, the CEO of Progress Corporation, has committed to helping revitalize the crumbling downtown area in his hometown. The area has experienced high unemployment as companies have left for the suburbs, and Mike is considering expanding his business and purchasing an old office building in a historic section of downtown. The building will require substantial renovations, and Mike has heard that there are tax credits that might help reduce his costs. He would also like to hire inner-city workers, and to help working families by providing on-site child care for working families. He is interested in learning whether his company might take advantage of any other tax credits offered by the Federal government that might reduce his costs. **Read the chapter and formulate your response.**

14.1 Tax Policy and Tax Credits

LO.1
Explain how tax credits are used as a tool of Federal tax policy.

Federal tax law often serves other purposes besides merely raising revenue for the government. Evidence of equity, social, and economic considerations, among others, is found throughout the tax law. These considerations also have considerable import in the area of **tax credits**. Congress has generally used tax credits to promote social or economic objectives or to work toward greater tax equity among different types of taxpayers. For example, the disabled access credit was enacted to accomplish a social objective: to encourage taxpayers to renovate older buildings so they would be in compliance with the Americans with Disabilities Act. This Act requires businesses and institutions to make their facilities more accessible to persons with various types of disabilities. As another example, the foreign tax credit, which has been a part of the law for decades, has as its chief purpose the economic and equity objectives of mitigating the burden of multiple taxation on a single stream of income.

A tax credit should not be confused with an income tax deduction. Certain expenditures (e.g., business expenses) are permitted as deductions from gross income in arriving at taxable income. While the tax benefit received from a tax deduction depends on the tax rate, a tax credit is not affected by the tax rate of the taxpayer. All taxpayers can benefit equally when a tax credit is used.

EXAMPLE 1

Assume Congress wishes to encourage a certain type of expenditure. One way to accomplish this objective is to allow a tax credit of 25% for such expenditures. Another way is to allow a deduction for the expenditures. Assume Red Corporation's tax rate is 15%, while Blue Corporation's tax rate is 34%. The following tax benefits are available to each corporation for a $1,000 expenditure.

TAX Talk

Where Have All the Credits Gone?

The number of individual income tax returns claiming tax credits has fluctuated over the years, usually due to tax law changes, revenue needs, and political requirements.

Year	Returns Claiming Credits (in Millions)
1975	65.9
1985	21.0
1995	15.2
2000	37.7
2007	48.1

Source: IRS Tax Statistics.

	Red	Blue
Tax benefit if a 25% credit is allowed	$250	$250
Tax benefit if a deduction is allowed	150	340

As these results indicate, tax credits can provide benefits on a more equitable basis than tax deductions often do. ■

14.2 Specific Business-Related Tax Credit Provisions

LO.2

Work with various business-related tax credits.

GENERAL BUSINESS CREDIT

As shown in Exhibit 14.1, the **general business credit** is comprised of a number of other credits, each of which is computed separately under its own set of rules. The general business credit combines these credits into one amount to limit the annual credit that can be used to offset a taxpayer's income tax liability. The idea behind combining the credits is to prevent a taxpayer from completely avoiding an income

TAX in the News

Many Taxpayers Become "Nonpayers" because of Tax Credits

One of the key domestic initiatives of the Bush administration was to reduce and then retain a lower marginal income tax rate structure as compared to prior law. Many opponents of this policy argued that the major beneficiaries of the lower tax rates were upper-income taxpayers who are the most affluent individuals in our country. However, Tax Foundation economists estimate that the legislation also led to more Americans than ever before being relieved of *any* Federal income tax liability. Since 2000, the number of "nonpayers" has grown by nearly 50 percent. More than 43 million Americans file a return and do not owe any taxes because of tax credits and deductions available to them.

Source: Adapted from Tax Foundation, *Tax Watch*, Summer 2006, p. 2.

EXHIBIT 14.1 Principal Components of the General Business Credit

The general business credit combines (but is not limited to) the following.

- Tax credit for rehabilitation expenditures
- Work opportunity tax credit
- Research activities credit
- Various energy credits
- Jobs credit
- Low-income housing credit
- Disabled access credit
- Credit for small employer pension plan startup costs
- Credit for employer-provided child care

tax liability in any one year by offsetting it with several business credits that would otherwise be available.

Two special rules apply to the general business credit. First, any unused credit is carried back 1 year, then forward 20 years. Second, for any tax year, the general business credit is limited to the taxpayer's *net income tax* reduced by the greater of:[1]

- The *tentative minimum tax* (see the discussion of AMT later in this chapter).
- 25 percent of *net regular tax liability* that exceeds $25,000.[2]

To understand these general business credit limitations, several terms need defining.

- *Net income tax* is the sum of the regular tax liability and the alternative minimum tax reduced by certain nonrefundable tax credits.
- *Tentative minimum tax* (discussed later in this chapter) is reduced by any foreign tax credit allowed, as specified in Exhibit 14.2.
- *Regular tax liability* is determined from the appropriate tax table or tax rate schedule, based on taxable income. However, the regular tax liability does not include certain taxes (e.g., alternative minimum tax).
- *Net regular tax liability* is the regular tax liability reduced by certain nonrefundable credits (e.g., foreign tax credit).

EXAMPLE 4

Tanager Corporation's general business credit for the current year is $70,000. Tanager's net income tax is $150,000, tentative minimum tax is $130,000, and net regular tax liability is $150,000. Tanager has no other tax credits. The general business credit allowed for the tax year is computed as follows.

Net income tax	$ 150,000
Less: The greater of—	
• $130,000 (tentative minimum tax)	
• $31,250 [25% × ($150,000 − $25,000)]	(130,000)
Amount of general business credit allowed for tax year	$ 20,000

Tanager then has $50,000 ($70,000 − $20,000) of unused general business credits that may be carried back or forward. ■

Treatment of Unused General Business Credits

Unused general business credits are initially carried back one year and reduce the tax liability of that year. Thus, the taxpayer may receive a tax refund as a result of the carryback. Any remaining unused credits are then carried forward 20 years.[3]

A FIFO method is applied to the carryback, carryovers, and utilization of credits earned during a particular year. The oldest credits are used first in determining the amount of the general business credit. The FIFO method minimizes the potential

[1] § 38(c). This rule works to keep the general business credit from completely eliminating the tax liability for many taxpayers.

[2] § 38(c)(3)(B). The $25,000 amount is apportioned among the members of a controlled group.

[3] § 39(a)(1).



BRIDGE TO FINANCE

When calculating the cash-flow benefit of particular tax attributes and making a decision based on this analysis, an inappropriate decision can be made unless present value analysis is incorporated into the calculation.

The general business credit and the related carryback and carryover provisions can be used to illustrate the cash-flow impact.

Blonde, Inc.'s general business credit for 2010 is $400,000. However, the amount that may be used to reduce the current-year tax liability is only $280,000. None can be used in 2009 (the carryback year), so the $120,000 is carried forward. The $120,000 of unused general business credit is expected to offset Blonde's future tax liability as follows.

2011	$20,000
2012	40,000
2013	60,000

It appears that the cash-flow benefit to Blonde is $400,000. In nominal dollars, this result is correct. However, when the present value concept is applied, the cash-flow benefit is only $376,280 (assuming Blonde's discount rate is 10 percent).

2010	$280,000 × 1.0	=	$280,000
2011	20,000 × .909	=	18,180
2012	40,000 × .826	=	33,040
2013	60,000 × .751	=	45,060
			$376,280

The carryforward period for the general business credit is 20 years. Using a 10 percent discount rate, one dollar in 20 years is worth $0.149 ($1 × .149) today. So it behooves the taxpayer to use the general business credit to offset tax liability as rapidly as possible.

for loss of a general business credit benefit due to the expiration of credit carryovers and generally works to the taxpayer's benefit.

EXAMPLE 3

This example illustrates the use of general business credit carryovers for the taxpayer's 2010 tax year.

General business credit carryovers (unused in prior tax years)		
2007	$ 4,000	
2008	6,000	
2009	2,000	
Total carryovers	$12,000	
2010 general business credit		$ 40,000
Total credit allowed in 2010 (based on tax liability)	$50,000	
Less: Carryovers used		
2007	(4,000)	
2008	(6,000)	
2009	(2,000)	
Remaining credit allowed in 2010	$38,000	
2010 general business credit used		(38,000)
2010 unused amount carried forward to 2011		$ 2,000

■

Most of the various credits that make up the general business credit are discussed in the paragraphs below.

TAX CREDIT FOR REHABILITATION EXPENDITURES

Taxpayers are allowed a tax credit for expenditures incurred to rehabilitate older industrial and commercial buildings and certified historic structures. The **rehabilitation expenditures credit** is intended to discourage businesses from moving from economically distressed areas (e.g., an inner city) to outlying locations and to encourage the preservation of historic structures. The current operating features of this credit follow.[4]

[4] § 47.

Rate of the Credit for Rehabilitation Expenses	Nature of the Property
10%	Nonresidential buildings and residential rental property, other than certified historic structures, originally placed in service before 1936
20%	Nonresidential and residential certified historic structures

Taxpayers who claim the rehabilitation credit must reduce the basis of the rehabilitated building by the credit allowed.[5]

EXAMPLE

Grosbeak, Inc., spent $60,000 to rehabilitate a building (adjusted basis of $40,000) that originally had been placed in service in 1932. Grosbeak is allowed a credit of $6,000 (10% × $60,000) for rehabilitation expenditures. The corporation then increases the basis of the building by $54,000 [$60,000 (rehabilitation expenditures) − $6,000 (credit allowed)]. If the building were a historic structure, the credit allowed would be $12,000 (20% × $60,000), and the building's depreciable basis would increase by $48,000 [$60,000 (rehabilitation expenditures) − $12,000 (credit allowed)]. ■

To qualify for the credit, buildings must be substantially rehabilitated. A building has been *substantially rehabilitated* if qualified rehabilitation expenditures exceed the *greater of*:

- the adjusted basis of the property before the rehabilitation expenditures, or
- $5,000.

Qualified rehabilitation expenditures do not include the cost of acquiring a building, the cost of facilities related to a building (such as a parking lot), and the cost of enlarging an existing building. Stringent rules apply concerning the retention of the building's original internal and external walls.

Recapture of Tax Credit for Rehabilitation Expenditures

The rehabilitation credit taken is recaptured if the rehabilitated property is disposed of prematurely or if it ceases to be qualifying property. The **rehabilitation expenditures credit recapture** is added to the taxpayer's regular tax liability in the recapture year. The recapture amount also is *added* to the adjusted basis of the building.

The portion of the credit recaptured is a specified percentage of the credit that was taken by the taxpayer. This percentage is based on the period the property was held by the taxpayer, as shown in Table 14.1. If the property is held at least five years, no recapture can result.

TABLE 14.1 Recapture Calculation for Rehabilitation Expenditures Credit

If the Property Is Held for	The Recapture Percentage Is
Less than 1 year	100
One year or more but less than 2 years	80
Two years or more but less than 3 years	60
Three years or more but less than 4 years	40
Four years or more but less than 5 years	20
Five years or more	0

[5] § 50(c).

EXAMPLE 4

On March 15, 2007, Chickadee Corporation rehabilitated a building qualifying for the 10% credit. The company spent $30,000 in qualifying rehabilitation expenditures and claimed a $3,000 credit ($30,000 × 10%). The basis of the building was increased by $27,000 ($30,000 − $3,000).

Chickadee sold the building on December 15, 2010. Chickadee recaptures a portion of the rehabilitation credit based on the schedule in Table 14.1. Because Chickadee held the rehabilitated property for more than three years but less than four, 40% of the credit, or $1,200, is added to the company's 2010 income tax liability. In addition, the adjusted basis of the building is increased by the $1,200 recapture amount. ■

WORK OPPORTUNITY TAX CREDIT

The **work opportunity tax credit**[6] was enacted to encourage employers to hire individuals from a variety of targeted and economically disadvantaged groups. Examples of such targeted persons include qualified ex-felons, high-risk youths, food stamp recipients, veterans, summer youth employees, and long-term family assistance recipients. For 2009 and 2010, the targeted persons also include unemployed veterans (discharged or released from active duty in 2008, 2009, and 2010 and recipients of unemployment benefits for at least four weeks during the year prior to being hired) and "disconnected youth" (age 16 to 25 when hired, not attending school and not employed for the six months prior to being hired, and not having sufficient skills to be employed).

Computation of the Work Opportunity Tax Credit: General

The credit generally is equal to 40 percent of the first $6,000 of wages (per eligible employee) for the first 12 months of employment. The credit is not available for wages paid to an employee after the *first year* of employment. If the employee's first year overlaps two of the employer's tax years, however, the employer may take the credit over two tax years. If the credit is claimed, the employer's tax deduction for wages is reduced by the amount of the credit.

To qualify an employer for the 40 percent credit, the employee must (1) be certified by a designated local agency as being a member of one of the targeted groups and (2) have completed at least 400 hours of service to the employer. If an employee meets the first condition but not the second, the credit is reduced to 25 percent, provided the employee has completed a minimum of 120 hours of service to the employer.

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.



EXAMPLE 5

In January 2010, Green hires four individuals who are certified to be members of a qualifying targeted group. Each employee works 1,000 hours and is paid wages of $8,000 during the year. Green's work opportunity credit is $9,600 [($6,000 × 40%) × 4 employees]. If the tax credit is taken, Green reduces its deduction for wages paid by $9,600. No credit is available for wages paid to these employees after their first year of employment. ■

EXAMPLE 6

On June 1, 2010, Maria, a calendar year taxpayer, hires Joe, a member of a certified group, and obtains the required certification to qualify Maria for the work opportunity credit. During his seven months of work in 2010, Joe is paid $3,500 for 500 hours of work. Maria is allowed a credit of $1,400 ($3,500 × 40%) for 2010.

Joe continues to work for Maria in 2011 and is paid $7,000 through May 31, 2011. Because up to $6,000 of first-year wages are eligible for the credit, Maria is also allowed a 40% credit on $2,500 [$6,000 − $3,500 (wages paid in 2010)] of 2011 wages paid, or $1,000 ($2,500 × 40%). None of Joe's wages paid after May 31, 2011, the end of the first year of employment, is eligible for the credit. ■

[6] § 51. The credit is available only if qualifying employees start work by August 31, 2011.

Computation of the Work Opportunity Tax Credit: Long-Term Family Assistance Recipient

The credit[7] is available to employers hiring individuals who have been long-term recipients of family assistance welfare benefits. In general, *long-term recipients* are those individuals who are certified by a designated local agency as being members of a family receiving assistance under a public aid program for the 18-month period ending on the hiring date. Unlike the work opportunity credit for other targeted groups, which applies only to first-year wages paid to qualified individuals, the credit is available for qualified wages paid in the first *two years* of employment if the employee is a long-term family assistance recipient. If an employee's first and second work years overlap two or more of the employer's tax years, the employer may take the credit during the applicable tax years.

The credit is equal to 40 percent of the first $10,000 of qualified wages paid to an employee in the first year of employment, plus 50 percent of the first $10,000 of qualified wages in the second year of employment, resulting in a maximum credit per qualified employee of $9,000 [$4,000 (year 1) + $5,000 (year 2)]. The credit rate is higher for second-year wages to encourage employers to retain qualified individuals, thereby promoting the overall welfare-to-work goal.

EXAMPLE 8

In April 2010, Blue hired three individuals who are certified as long-term family assistance recipients. Each employee is paid $12,000 during 2010. Two of the three individuals continue to work for Blue in 2011, earning $9,000 each during the year. Blue's work opportunity tax credit is $12,000 [(40% × $10,000) × 3 employees] for 2010 and $9,000 [(50% × $9,000) × 2 employees] for 2011. In each year, Blue must reduce its deduction for wages paid by the amount of the credit for that year. ■

RESEARCH ACTIVITIES CREDIT

To encourage research and development (R & D) in the U.S. business community, a credit is allowed for certain qualifying expenditures paid or incurred by a taxpayer. The **research activities credit** is the *sum* of three components: (1) an incremental research activities credit, (2) a basic research credit, and (3) an energy research credit.[8]

Incremental Research Activities Credit

The incremental research activities credit applies at a 20 percent rate to the *excess* of qualified research expenses for the taxable year (the credit year) over a base amount.[9]

In general, *research expenditures* qualify if the research relates to discovering technological information that is intended for use in the development of a new or improved business component of the taxpayer. Such expenses qualify fully if the research is performed in-house (by the taxpayer or its employees). If the research is conducted by persons outside the taxpayer's business (under contract), only 65 percent of the amount paid qualifies for the credit.[10]

EXAMPLE 9

Bobwhite Company incurs the following research expenditures:

In-house wages, supplies, computer time	$50,000
Payment to Cutting Edge Scientific Foundation for research	30,000

Bobwhite's qualified research expenditures are $69,500 [$50,000 + ($30,000 × 65%)]. ■

[7]Prior to 2007, this component of the work opportunity tax credit was called the welfare-to-work credit, provided for under § 51A. Under current law, long-term family assistance recipients are a designated targeted group under the work opportunity tax credit, and the maximum credit is now slightly more generous than under prior law. § 51(d)(1)(I).

[8]§ 41. Each component of the research credit is available only if qualifying expenditures are paid or incurred by December 31, 2009. Congress is expected to extend the credit through 2010.

[9]In lieu of determining the incremental research credit as described here, a taxpayer may elect to calculate the credit using an alternative simplified credit procedure. See §§ 41(c)(4) and (5).

[10]§ 41(b)(3)(A). In the case of payments to a qualified research consortium, § 41(b)(3)(A) provides that 75% of the amount paid qualifies for the credit. In contrast, for amounts paid to an energy research consortium, § 41(b)(3)(D) allows the full amount to qualify for the credit.

Beyond the general guidelines described above, the Code does not give specific examples of qualifying research. However, the credit is *not* allowed for research that falls into certain categories, including the following.[11]

- Research conducted after the beginning of commercial production of the business component.
- Surveys and studies such as market research, testing, or routine data collection.
- Research conducted *outside* the United States (other than research undertaken in Puerto Rico or possessions of the United States).
- Research in the social sciences, arts, or humanities.

Determining the *base amount* involves a relatively complex series of computations, meant to approximate recent historical levels of research activity by the taxpayer. Thus, the credit is allowed only for increases in research expenses.

EXAMPLE 10

Hawk, Inc., a calendar year taxpayer, incurs qualifying research expenditures of $200,000 during the year. If the base amount is $100,000, the incremental research activities credit is $20,000 [($200,000 − $100,000) × 20%]. ■

Qualified research and experimentation expenditures are not only eligible for the 20 percent credit, but can also be *expensed* in the year incurred. In this regard, a taxpayer has two choices.[12]

- Use the full credit and reduce the expense deduction for research expenses by 100 percent of the credit.
- Retain the full expense deduction and reduce the credit by the product of 100 percent of the credit times the maximum corporate tax rate (35 percent).

As an alternative to the expense deduction, the taxpayer may *capitalize* the research expenses and *amortize* them over 60 months or more. In this case, the amount capitalized and subject to amortization is reduced by the full amount of the credit *only* if the credit exceeds the amount allowable as a deduction.

EXAMPLE 11

Assume the same facts as in Example 10, which shows that the potential incremental research activities credit is $20,000. In the current year, the amounts that Hawk can deduct and the credit amount are computed as follows.

	Credit Amount	Deduction Amount
• Full credit and reduced deduction		
$20,000 − $0	$20,000	
$200,000 − $20,000		$180,000
• Reduced credit and full deduction		
$20,000 − [(100% × $20,000) × 35%]	13,000	
$200,000 − $0		200,000
• Full credit and capitalize and elect to amortize costs over 60 months		
$20,000 − $0	20,000	
($200,000/60) × 12		40,000

The value of the deduction depends on Hawk's marginal tax rates. ■

[11] § 41(d).

[12] §§ 174 and 280C(c). Recall the discussion of rules for deducting research and experimental expenditures in Chapter 5.

Basic Research Credit

Corporations (other than S corporations or personal service corporations) are allowed an additional 20 percent credit for basic research expenditures incurred, in *excess* of a base amount.[13] This credit is not available to individual taxpayers. *Basic research expenditures* are defined as amounts paid in cash to a qualified basic research organization, such as a college or university or a tax-exempt organization operated primarily to conduct scientific research.

Basic research is defined generally as any original investigation for the advancement of scientific knowledge not having a specific commercial objective. The definition excludes basic research conducted outside the United States and basic research in the social sciences, arts, or humanities.

Energy Research Credit

This component of the research credit is intended to stimulate additional energy research. The calculation of the credit is relatively straightforward; it is equal to 20 percent of the amounts paid or incurred by a taxpayer to an energy research consortium for energy research.

ENERGY CREDITS

The Internal Revenue Code contains a variety of credits for businesses and individuals to encourage the conservation of natural resources and the development of energy sources other than oil and gas. The primary goals of the tax provisions are to improve energy-related infrastructure and encourage higher levels of energy conservation.

Some of the more widely applicable provisions include credits for:

- Builders who construct energy-efficient homes.
- Individuals who make energy-saving improvements to their residences.
- Manufacturers that make energy-efficient appliances.
- Businesses that buy fuel cell and microturbine power plants.
- Taxpayers who purchase alternative power motor vehicles and refueling property.

Like many other tax credits, the **energy credits** have been designed to modify taxpayer behavior. More specifically, in this case, Congress's intention is that these credits will lead to greater conservation and more efficient use of energy.



In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

JOBS CREDIT

A $1,000 jobs credit is allowed for every unemployed individual who is hired and works for the employer for at least 52 consecutive weeks. The employee's wages during 13 of the last 26 weeks of work must equal at least 80 percent of the wages for the first 26 weeks of employment. The credit applies to any tax year ending after the date of enactment of the 2010 jobs bill.

DISABLED ACCESS CREDIT

The **disabled access credit** is designed to encourage small businesses to make their facilities more accessible to disabled individuals. The credit is available for any eligible access expenditures paid or incurred by an eligible small business. The credit is calculated at the rate of 50 percent of the eligible expenditures that

[13] § 41(e).

exceed $250 but do not exceed $10,250. Thus, the maximum amount for the credit is $5,000 ($10,000 × 50%).[14]

An *eligible small business* is one that during the previous year either had gross receipts of $1 million or less or had no more than 30 full-time employees. A sole proprietorship, partnership, regular corporation, or S corporation can qualify as such an entity.

Eligible access expenditures generally include any reasonable and necessary amounts that are paid or incurred to make certain changes to facilities. These changes must involve the removal of architectural, communication, physical, or transportation barriers that would otherwise make a business inaccessible to disabled and handicapped individuals. Examples of qualifying projects include installing ramps, widening doorways, and adding raised markings on elevator control buttons. The improved facility must have been placed into service prior to November 5, 1990.

To the extent a disabled access credit is available, no deduction or credit is allowed under any other provision of the tax law. The asset's adjusted basis is reduced by the amount of the credit.

EXAMPLE 12

This year Red, Inc., an eligible business, makes $11,000 of capital improvements to business realty that had been placed in service in June 1990. The expenditures are intended to make Red's business more accessible to the disabled and are considered eligible expenditures for purposes of the disabled access credit. The amount of the credit is $5,000 [($10,250 maximum − $250 floor) × 50%]. The depreciable basis of the capital improvement is $6,000 [$11,000 (cost) − $5,000 (amount of the credit)]. ■

CREDIT FOR SMALL EMPLOYER PENSION PLAN STARTUP COSTS

Small businesses are entitled to a nonrefundable credit for administrative costs associated with establishing and maintaining certain qualified retirement plans.[15] While such costs (e.g., payroll system changes, consulting fees) generally are deductible as ordinary and necessary business expenses, the credit is intended to lower the after-tax cost of establishing a qualified retirement program and thereby to encourage qualifying businesses to offer retirement plans for their employees.

The **credit for small employer pension plan startup costs** is available for eligible employers at the rate of 50 percent of qualified startup costs. An eligible employer is one with fewer than 100 employees who have earned at least $5,000 of compensation. The maximum credit is $500 (based on a maximum $1,000 of qualifying expenses), and the deduction for the startup costs incurred is reduced by the amount of the credit. The credit can be claimed for qualifying costs incurred in each of the three years beginning with the tax year in which the retirement plan becomes effective (maximum total credit of $1,500).

EXAMPLE 13

Maple Company decides to establish a qualified retirement plan for its employees. In the process, it pays consulting fees of $1,200 to a firm that will provide educational seminars to Maple's employees and will assist the payroll department in making necessary changes to the payroll system. Maple may claim a credit for the pension plan startup costs of $500 ($1,200 of qualifying costs, limited to $1,000 × 50%), and its deduction for these expenses is reduced to $700 ($1,200 − $500). ■

CREDIT FOR EMPLOYER-PROVIDED CHILD CARE

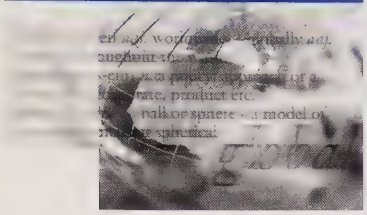
An employer can deduct expenditures incurred to provide for the care of children of employees as ordinary and necessary business expenses. Alternatively, employers may claim a credit for qualifying expenditures incurred while providing child care facilities to their employees during normal working hours.[16]

[14] § 44.

[15] § 45E. Currently, this credit is scheduled to expire for years beginning after 2010.

[16] § 45F. Currently, this credit is scheduled to expire for years beginning after 2010.

GLOBAL *Tax Issues*



Sourcing Income in Cyberspace—Getting It Right When Calculating the Foreign Tax Credit

The overall limitation on the foreign tax credit plays a critical role in restricting the amount of the credit available to a taxpayer. In the overall limitation formula, the taxpayer must characterize the year's taxable income as either earned (or sourced) inside or outside the United States. As a general rule, a relatively greater percentage of foreign-source income in the formula leads to a larger foreign tax credit. But classifying income as either foreign or U.S. source is not always a simple matter.

The existing income-sourcing rules were developed long before the existence of the Internet, and taxing authorities are finding it challenging to apply these rules to Internet transactions. Where does a sale take place when the web server is in Scotland, the seller is in India, and the customer is in Illinois? Where is a service performed when all activities take place over the Net? These questions and more must be answered by the United States and its trading partners as the Internet economy grows in size and importance.

The **credit for employer-provided child care**, limited annually to $150,000, is composed of the aggregate of two components: 25 percent of qualified child care expenses and 10 percent of qualified child care resource and referral services. *Qualified child care expenses* include the costs of acquiring, constructing, rehabilitating, expanding, and operating a child care facility. *Child care resource and referral services* include amounts paid or incurred under a contract to provide child care resource and referral services to an employee.

Any qualifying expenses otherwise deductible by the taxpayer are reduced by the amount of the credit. In addition, the taxpayer's basis for any property acquired or constructed and used for qualifying purposes is reduced by the amount of the credit. If within 10 years of being placed in service, a child care facility ceases to be used for a qualified use, the taxpayer recaptures a portion of the credit previously claimed.[17]

EXAMPLE 16

During the year, Tan Company constructed a child care facility for $400,000 to be used by its employees who have preschool-aged children in need of child care services while their parents are at work. In addition, Tan incurred salaries for child care workers and other administrative costs associated with the facility of $100,000 during the year. As a result, Tan's credit for employer-provided child care is $125,000 [($400,000 + $100,000) × 25%]. Correspondingly, the basis of the facility is reduced to $300,000 ($400,000 − $100,000), and the deduction for salaries and administrative costs is reduced to $75,000 ($100,000 − $25,000). ■

DIGGING DEEPER 3

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

FOREIGN TAX CREDIT

Both individual taxpayers and corporations may claim a credit for foreign income tax paid on income earned and subject to tax in another country or a U.S. possession.[18] The purpose of the **foreign tax credit (FTC)** is to reduce the possibility of double taxation of foreign income.

[17] § 45F(d).

[18] § 27 provides for the credit, but the qualifications and calculation procedure for the credit are contained in §§ 901–908. Alternatively, the taxpayer can *deduct* the foreign taxes paid.

EXAMPLE 15

Ace Tools, Inc., a U.S. corporation, has a branch operation in Mexico, from which it earns taxable income of $750,000 for the current year. Ace pays income tax of $150,000 on these earnings to the Mexican tax authorities. Ace must also include the $750,000 in gross income for U.S. tax purposes. Assume that, before considering the FTC, Ace would owe $255,000 in U.S. income taxes on this foreign-source income. Thus, total taxes on the $750,000 could equal $405,000 ($150,000 + $255,000), a 54% effective rate. But Ace takes the FTC of $150,000 against its U.S. tax liability on the foreign-source income. Ace Tools' total taxes on the $750,000 now are $255,000 ($150,000 + $105,000), a 34% effective rate. ■

The tax year's FTC equals the *lesser* of the foreign taxes imposed or the *overall limitation* determined according to the following formula. Thus, where applicable foreign tax rates exceed those of the United States, the credit offsets no more than the marginal U.S. tax on the double-taxed income.

$$\frac{\text{Foreign-source taxable income}}{\text{Worldwide taxable income}} \times \text{U.S. tax before FTC}$$

Foreign taxes paid but not allowed as a credit due to the overall limitation are carried back 1 tax year and then forward 10 years.[19]

EXAMPLE 16

Oriole, Inc., a U.S. corporation, conducts business in a foreign country. Oriole's worldwide taxable income for the tax year is $120,000, consisting of $100,000 in income from U.S. operations and $20,000 of income from the foreign source. Foreign tax of $6,000 was paid to foreign tax authorities on the $20,000. Before the FTC, Oriole's U.S. tax on the $120,000 is $30,050. The corporation's FTC is $5,008 {lesser of $6,000 paid or $5,008 limitation [$30,050 × ($20,000/$120,000)]}. Oriole's net U.S. tax liability is $25,042 ($30,050 − $5,008). Thus, Oriole carries over (back 1 year and forward 10 years) $992 FTC ($6,000 − $5,008) because of the overall limitation. ■

14.3 Corporate Alternative Minimum Tax

LO.3

Explain the reason for the alternative minimum tax.

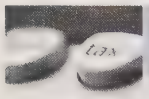
A perception that many large corporations were not paying their fair share of Federal income tax was especially widespread in the early 1980s. A study released in 1986 reported that 130 of the 250 largest corporations in the United States (e.g., Reynolds Metals, General Dynamics, Georgia Pacific, and Texas Commerce Bankshares) paid no Federal tax, or received refunds, in at least one year between 1981 and 1985. Political pressure subsequently led to the adoption of an **alternative minimum tax (AMT)** to ensure that corporations with substantial economic income pay at least a minimum amount of Federal taxes.

The AMT limits the tax savings for some taxpayers who are seen as gaining "too much" from exclusions, deductions, and credits available under the law. A separate tax system with a proportional tax rate is applied each year to a corporation's economic income. If the tentative AMT is greater than the regular corporate income tax, then the corporation must pay the regular tax plus this excess, the AMT.

Since its inception, the AMT has been vulnerable to criticisms that it is too complex. Smaller corporations especially find that the imposition of a second tax structure unduly increases their compliance burdens. Thus, under current rules most smaller corporations are not subject to the AMT at all. A corporation is exempted from the AMT if it meets the following tests.

- *Initial test.* The corporation must report average annual gross receipts of no more than $5 million for the latest three-year period.
- *Ongoing test.* If the initial test is passed, the corporation is exempt from the AMT as long as its average annual gross receipts for the three-year period preceding the current tax year and any intervening three-year periods do not exceed $7.5 million.

[19] § 904(c).



CONCEPT SUMMARY 14.1

Tax Credits

Credit	Computation	Comments
General business (§ 38)	May not exceed net income tax minus the greater of tentative minimum tax or 25% of net regular tax liability that exceeds $25,000.	Components include tax credit for rehabilitation expenditures, work opportunity tax credit, research activities credit, low-income housing credit, disabled access credit, credit for small employer pension plan startup costs, and credit for employer-provided child care. Unused credit may be carried back 1 year and forward 20 years. FIFO method applies to carrybacks, carryovers, and credits earned during current year.
Rehabilitation expenditures (§ 47)	Qualifying investment times rehabilitation percentage, depending on type of property. Regular rehabilitation rate is 10%; rate for certified historic structures is 20%.	Part of general business credit and therefore subject to same carryback, carryover, and FIFO rules. Purpose is to discourage businesses from moving from economically distressed areas to new locations.
Work opportunity (§ 51)	Credit is limited to 40% of the first $6,000 of wages paid to each eligible employee. For long-term family assistance recipients, credit is limited to 40% of first $10,000 of wages paid to each eligible employee in first year of employment, plus 50% of first $10,000 of wages paid to same employee in second year of employment.	Part of the general business credit and therefore subject to the same carryback, carryover, and FIFO rules. Purpose is to encourage employment of members of economically disadvantaged groups.
Research activities (§ 41)	Incremental credit is 20% of excess of computation-year expenditures over a base amount. Basic research credit is allowed to certain corporations for 20% of cash payments to qualified organizations that exceed a specially calculated base amount. An energy research credit is allowed for 20% of qualifying payments made to an energy research consortium.	Part of general business credit and therefore subject to same carryback, carryover, and FIFO rules. Purpose is to encourage high-tech and energy research in the United States.
Low-income housing (§ 42)	Appropriate rate times eligible basis (portion of project attributable to low-income units).	Part of general business credit and therefore subject to same carryback, carryover, and FIFO rules. Recapture may apply. Purpose is to encourage construction of housing for low-income individuals. Credit is available each year for 10 years.
Energy credits	Various items to encourage individuals and businesses to "go green."	Part of general business credit and therefore subject to same carryback, carryover, and FIFO rules.
Disabled access (§ 44)	Credit is 50% of eligible access expenditures that exceed $250, but do not exceed $10,250. Maximum credit is $5,000.	Part of general business credit and therefore subject to same carryback, carryover, and FIFO rules. Purpose is to encourage small businesses to become more accessible to disabled individuals. Available only to eligible small businesses.
Credit for small employer pension plan startup costs (§ 45E)	The credit equals 50% of qualified startup costs incurred by eligible employers. Maximum annual credit is $500. Deduction for related expenses is reduced by the amount of the credit.	Part of general business credit and therefore subject to same carryback, carryover, and FIFO rules. Purpose is to encourage small employers to establish qualified retirement plans for their employees.

Tax Credits—Continued

Credit	Computation	Comments
Credit for employer-provided child care (§ 45F)	Credit is equal to 25% of qualified child care expenses plus 10% of qualified expenses for child care resource and referral services. Maximum credit is $150,000. Deduction for related expenses or basis must be reduced by the amount of the credit.	Part of general business credit and therefore subject to same carryback, carryover, and FIFO rules. Purpose is to encourage employers to provide child care for their employees' children during normal working hours.
Foreign tax (§ 27)	Foreign taxable income/total worldwide taxable income × U.S. tax = overall limitation. Lesser of foreign taxes imposed or overall limitation.	Unused credits may be carried back 1 year and forward 10 years. Purpose is to reduce double taxation of foreign income.

This provision exempts up to 95 percent of all C corporations from the AMT. A corporation *automatically* is classified as a small corporation in the first tax year of existence. A corporation that fails the initial test *never* (other than the first year exception) can be exempt from the AMT. Furthermore, if the ongoing test is failed, the taxpayer is subject to the AMT provisions for that year and all subsequent tax years.

THE AMT FORMULA

The AMT is imposed in addition to the regular corporate income tax, but is computed in a manner wholly separate and independent from it.[20] The AMT is a parallel income tax system that generally uses more conservative accounting methods than the regular income tax. Typically, more items are subject to tax under AMT rules, some gross income items are accelerated, and some deductions are deferred.

The formula for determining the AMT liability of corporate taxpayers appears in Exhibit 14.2 and follows the format of Form 4626 (Alternative Minimum Tax—Corporations).

The base for the AMT, **alternative minimum taxable income (AMTI)**, begins with regular taxable income before any deductions for net operating losses (NOLs). A series of adjustments are then made. Most AMT adjustments relate to *timing differences* that arise because of separate regular income tax and AMT treatments. Adjustments that are caused by timing differences eventually reverse; that is, positive adjustments are offset by negative adjustments in the future, and vice versa.

The adjustments related to *circulation expenditures* illustrate this concept. Circulation expenditures include expenses incurred to establish, maintain, or increase the circulation of a newspaper, magazine, or other periodical.

In computing *taxable income*, corporations that are personal holding companies are allowed to deduct circulation expenditures in the year incurred. In computing AMTI, however, these expenditures must be capitalized and amortized ratably over the three-year period beginning with the year in which the expenditures were made.

EXAMPLE 17

Bobwhite, Inc., a personal holding company, incurred circulation expenditures of $30,000 in 2010. For regular income tax purposes, Bobwhite deducts $30,000 in 2010. For AMT purposes, the corporation is required to capitalize the expenditures and amortize them over a three-year period. Therefore, the deduction for AMT purposes is only $10,000. The AMT adjustment for 2010 is computed as follows.

Circulation expenditures deducted for regular income tax purposes	$ 30,000
Circulation expenditures deducted for AMT purposes	(10,000)
AMT adjustment (positive)	$ 20,000

■

[20]The AMT provisions are contained in §§ 55 through 59.

EXHIBIT 14.2 AMT Formula for Corporations

Regular taxable income before NOL deduction
Plus/minus: AMT adjustments (except ACE adjustment)
Plus: Tax preferences
Equals: AMTI before AMT NOL deduction and ACE adjustment
Plus/minus: ACE adjustment
Equals: AMTI before AMT NOL deduction
Minus: AMT NOL deduction (limited to 90%)
Equals: Alternative minimum taxable income (AMTI)
Minus: Exemption
Equals: AMT base
Times: 20% rate
Equals: Tentative AMT before AMT foreign tax credit
Minus: AMT foreign tax credit
Equals: Tentative minimum tax
Minus: Regular income tax liability before credits minus regular foreign tax credit
Equals: Alternative minimum tax (AMT) if positive

EXAMPLE 18

Assume the same facts as in Example 17. The timing difference that gave rise to the positive adjustment in 2010 will reverse in the future. For AMT purposes, Bobwhite will deduct $10,000 in 2011 and $10,000 in 2012. The regular income tax deduction for circulation expenditures in each of those years will be $0, because the entire $30,000 expenditure was deducted in 2010. This results in a negative AMT adjustment of $10,000 each in 2011 and 2012. The AMT adjustments over the three-year period are summarized below.

Year	Regular Income Tax Deduction	AMT Deduction	AMT Adjustment
2010	$30,000	$10,000	$ 20,000
2011	–0–	10,000	(10,000)
2012	–0–	10,000	(10,000)
Totals	$30,000	$30,000	$ –0–

Timing differences eventually reverse. Thus, positive AMT adjustments can be offset later by negative adjustments. ■

LO.4

Identify and calculate the tax preferences that are included in determining the AMT.

TAX PREFERENCES

AMTI includes designated **tax preference items**. In many cases, this part of the AMT formula has the effect of subjecting otherwise nontaxable income to the AMT. Tax preferences always increase AMTI. Some of the principal tax preferences are discussed below.

Percentage Depletion

Congress originally enacted the percentage depletion rules to provide taxpayers with incentives to invest in the development of specified natural resources. Percentage depletion is computed by multiplying a rate specified in the Code times the gross income from the property (refer to Chapter 5). The percentage rate is based on the type of mineral involved. The basis of the property is reduced by the amount of depletion taken until the basis reaches zero. However, once the basis of the property reaches zero, taxpayers are allowed to continue taking percentage depletion deductions. Thus, over the life of the property, depletion deductions may greatly exceed the cost of the property.

TAX FACT

THE REACH OF THE AMT

The total number of returns subject to the individual AMT is projected to increase as follows.

Year	Number of Returns
2000	1,300,000
2005	3,500,000
2011	35,500,000

Tax year 2005 is representative of the increases that are likely to occur because of the AMT unless the Code is modified.

Number of returns with AMT	3,500,000
Percentage increase in number of returns with AMT over prior year	12.9%
Percentage increase in AMT liability over prior year	16.3%
Revenue generated by AMT	$11 billion

The revenue generated by the corporate AMT as a percentage of corporate tax liabilities, however, is declining. The probable cause for this decline is the exemption from the AMT for small corporations.

Year	AMT as Percentage of Corporate Tax Liabilities
1990	8.0%
2000	1.8%
2005	1.7%

The percentage depletion preference is equal to the excess of the regular income tax deduction for percentage depletion over the adjusted basis of the property at the end of the taxable year.[21] Basis is determined without regard to the depletion deduction for the taxable year. This preference item is figured separately for each piece of property for which the taxpayer is claiming depletion.

EXAMPLE 19

Finch, Inc., owns a mineral property that qualifies for a 22% depletion rate. The basis of the property at the beginning of the year is $10,000. Gross income from the property for the year is $100,000. For regular income tax purposes, Finch's percentage depletion deduction (assume it is not limited by taxable income from the property) is $22,000. For AMT purposes, Finch has a tax preference of $12,000 ($22,000 − $10,000). ■

Interest on Private Activity Bonds

Income from private activity bonds is not included in taxable income, and expenses related to carrying such bonds are not deductible for regular income tax purposes. However, interest on private activity bonds usually is included as a preference in computing AMTI. Expenses incurred in carrying the bonds are offset against the interest income in computing the tax preference.[22] However, interest on private activity bonds issued after 2008 and before 2011 is not a tax preference.

[21] § 57(a)(1). Percentage depletion on oil and gas wells taken by independent producers and royalty owners does not create an AMT preference. See § 613A(c).

[22] § 57(a)(5).

TAX in the NEWS

The AMT: From 155 to 35.5 Million

Often the tax law is changed to prevent or reduce certain perceived abuses. Such was the case when the AMT was enacted in 1969. The identifiable perceived abuse was that 155 individual taxpayers had zero Federal income tax liability despite having incomes in excess of $200,000.

Thus, the original idea behind the AMT was one of fairness, based on the premise that taxpayers with significant economic income should pay at least a minimum amount of tax. Although this idea has not changed, the tax is fast becoming anything but fair, according to most observers. That same concept of fairness later led Nina Olsen, the IRS's Taxpayer Advocate, to identify the expanding scope of the AMT as the number one problem facing taxpayers that needs to be legislatively addressed. A key problem is that Congress has not significantly updated the provisions of the AMT to account for inflation.

What has caused this shift in what is deemed fair? The idea that taxpayers with significant economic income should pay at least a minimum amount of tax has not changed. What is new is the number of taxpayers that are becoming subject to the AMT—an estimated 35.5 million taxpayers in 2011 if the law is not changed. Thus, a tax that was perceived as fair when it affected only a "few" now is perceived as unfair because it affects "many."

The Code contains a lengthy, complex definition of **private activity bonds**.[23] In general, such debt is issued by states or municipalities, but more than 10 percent of the proceeds are used to benefit private business. For example, a bond issued by a city whose proceeds are used to construct a factory that is leased to a private business at a favorable rate is a private activity bond.

The vast majority of tax-exempt bonds issued by states and municipalities are not classified as private activity bonds. Therefore, the interest income from such bonds is not a tax preference item.

DIGGING DEEPER 4

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

LO.5

Identify and calculate AMT adjustments.

AMT ADJUSTMENTS

As Exhibit 14.2 indicates, the starting point for computing AMTI is the taxable income of the corporation before any NOL deduction. Certain *adjustments* must be made to this amount. Unlike tax preference items, which always increase AMTI, the adjustments may be either increases or decreases to taxable income.

Although NOLs are stated separately in Exhibit 14.2, they are actually negative adjustments. They are listed separately in Exhibit 14.2 and on Form 4626 because they may not exceed more than 90 percent of AMTI. Thus, such adjustments cannot be determined until all other adjustments and tax preference items are considered.

Computing Adjustments

It is necessary to determine not only the amount of an adjustment, but also whether the adjustment is positive or negative. Careful study of Examples 17 and 18 reveals the following pattern with regard to *deductions*.

- If the deduction allowed for regular income tax purposes exceeds the deduction allowed for AMT purposes, the difference is a positive adjustment.
- If the deduction allowed for AMT purposes exceeds the deduction allowed for regular income tax purposes, the difference is a negative adjustment.

[23] § 141.

TAX in the News

Distinguishing between Taxable and Exempt Bonds for AMT Purposes

Interest on state and local bonds generally is exempt from the regular income tax, but it may be subject to the AMT.

If the security is a private activity bond, then the interest usually is a tax preference for AMT purposes. According to the Bond Market Association, interest from almost 8.7 percent of the $1.9 trillion municipal bond market is subject to the AMT. The association's website (**investinginbonds.com**) provides a primer on the AMT's effect on municipal bonds and explains how to determine if the related interest is subject to the AMT.

The IRS developed a free online calculator to help taxpayers determine if they are subject to the 2009 AMT (e.g., **apps.irs.gov/app/amt2009**).

Conversely, the direction of an adjustment attributable to an *income* item can be determined as follows.

- If the income reported for regular income tax purposes exceeds the income reported for AMT purposes, the difference is a negative adjustment.
- If the income reported for AMT purposes exceeds the income reported for regular income tax purposes, the difference is a positive adjustment.

The principal AMT adjustments are discussed below. The adjustment for circulation expenditures was discussed previously.

Depreciation of Post-1986 Real Property

Tax legislation enacted in 1997 eliminated the AMT depreciation adjustment for real property by providing that the MACRS recovery periods (see Table 5.3) used in calculating the regular income tax apply in calculating the AMT. Note, however, that this AMT recovery period conformity provision applies only to property placed in service after 1998.[24] Thus, the AMT depreciation adjustment discussed below applies only for real property placed in service before 1999.

For real property placed in service after 1986 (MACRS property) and before 1999, AMT depreciation is computed under the alternative depreciation system (ADS), which uses the straight-line method over a 40-year life. The depreciation lives for regular income tax purposes are 27.5 years for residential rental property and 39 years for all other real property.[25] The difference between AMT depreciation and regular income tax depreciation is treated as an adjustment in computing the AMT. The differences will be positive during the regular income tax life of the asset because the cost is written off over a shorter period for regular income tax purposes. For example, during the 27.5-year income tax life of residential real property, the regular income tax depreciation will exceed the AMT depreciation because AMT depreciation is computed over a 40-year period.

Table 5.3 is used to compute regular income tax depreciation on real property placed in service after 1986. For AMT purposes, depreciation on real property placed in service after 1986 and before 1999, is computed under the ADS (refer to Table 5.7).

In January 1998, Robin Rentals placed in service a residential building that cost $100,000. Regular income tax depreciation, AMT depreciation, and the AMT adjustment are as follows.

[24] § 56(a)(1)(A)(i).

[25] The 39-year life generally applies to nonresidential real property placed in service on or after May 13, 1993.

Year	Depreciation: Regular Income Tax	Depreciation: AMT	AMT Adjustment
1998	$ 3,485[1]	$ 2,396[2]	$ 1,089
1999	3,636[3]	2,500[4]	1,136
2000	3,636	2,500	1,136
2001	3,636	2,500	1,136
2002	3,636	2,500	1,136
2003	3,636	2,500	1,136
2004	3,636	2,500	1,136
2005	3,636	2,500	1,136
2006	3,636	2,500	1,136
2007	3,636	2,500	1,136
2008	3,636	2,500	1,136
2009	3,636	2,500	1,136
2010	3,636	2,500	1,136
Total	$47,117	$32,396	$14,721

[1]$100,000 cost × 3.485% (Table 5.3) = $3,485
[2]$100,000 cost × 2.396% (Table 5.7) = $2,396
[3]$100,000 cost × 3.636% (Table 5.3) = $3,636
[4]$100,000 cost × 2.500% (Table 5.7) = $2,500

If the building had been placed in service after 1998, there would have been no AMT depreciation adjustment for the tax year it is placed in service or for subsequent years. The depreciation for the tax year the building was placed in service for both regular income tax purposes and AMT purposes would have been $3,485 ($100,000 × 3.485%). ■

After real property placed in service before 1999 has been held for the entire depreciation period for regular income tax purposes, the asset is fully depreciated. However, the depreciation period under the ADS is 41 years due to application of the mid-month convention, so depreciation will continue for AMT purposes. This causes negative adjustments after the property has been fully depreciated for regular income tax purposes.

EXAMPLE 21

Assume the same facts as in the previous example for the building placed in service in 1998. Regular income tax depreciation in the year 2026 (the twenty-ninth year of the asset's life) is zero (refer to Table 5.3). AMT depreciation is $2,500 ($100,000 cost × 2.500% from Table 5.7). Therefore, Robin has a negative AMT adjustment of $2,500 ($0 regular income tax depreciation − $2,500 AMT depreciation). ■

After real property is fully depreciated for both regular income tax and AMT purposes, the positive and negative adjustments that have been made for AMT purposes will net to zero.

Depreciation of Post-1986 Personal Property

For most personal property placed in service after 1986 (MACRS property), the MACRS deduction for regular income tax purposes is based on the 200 percent declining-balance method with a switch to straight-line when that method produces a larger depreciation deduction for the asset. Refer to Table 5.1 for computing regular income tax depreciation.

For AMT purposes, the taxpayer must use the ADS for such property placed in service before 1999. This method is based on the 150 percent declining-balance method with a similar switch to straight-line for all personal property.[26] Refer to Table 5.5 for percentages to be used in computing AMT depreciation.

[26]§ 56(a)(1).

The MACRS deduction for personal property is larger than the ADS deduction in the early years of an asset's life. However, the ADS deduction is larger in the later years. This is so because ADS lives are sometimes longer than MACRS lives and use less accelerated depreciation methods.[27] Over the ADS life of the asset, the same aggregate amount of depreciation is deducted for both regular income tax and AMT purposes. In the same manner as other timing adjustments, the AMT adjustments for depreciation will net to zero over the ADS life of the asset.

The taxpayer may elect to use the ADS for regular income tax purposes. If this election is made, no AMT adjustment is required because the depreciation deduction is the same for regular income tax and for the AMT. The election eliminates the burden of maintaining two sets of tax depreciation records at the cost of a higher regular tax liability.

For personal property placed in service after 1998, MACRS recovery periods are used in calculating AMT depreciation, but the 150 percent declining-balance method still is used. Thus, if the taxpayer elects to use the 150 percent declining-balance method for regular income tax purposes, there are no AMT adjustments. Conversely, if the taxpayer uses the 200 percent declining-balance method for regular income tax purposes, there is an AMT adjustment for depreciation.

Pollution Control Facilities

For regular income tax purposes, the cost of certified pollution control facilities may be amortized over a period of 60 months. For AMT purposes, the cost of these facilities placed in service after 1986 and before 1999 is depreciated under the ADS over the appropriate class life, determined as explained above for depreciation of post-1986 property.[28] The required adjustment for AMTI is the difference between the amortization deduction allowed for regular income tax purposes and the depreciation deduction computed under the ADS. The adjustment may be positive or negative.

The AMT adjustment for pollution control facilities is reduced for property placed in service after 1998. This reduction is achieved by providing conformity in the recovery periods used for regular income tax purposes and AMT purposes (MACRS recovery periods).

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

5 DIGGING DEEPER

Use of Completed Contract Method of Accounting

For a long-term contract, taxpayers are required to use the percentage of completion method for AMT purposes.[29] However, in limited circumstances, taxpayers can use the completed contract method for regular income tax purposes.[30] The resulting AMT adjustment is equal to the difference between income reported under the percentage of completion method and the amount reported using the completed contract method.[31] The adjustment can be either positive or negative, depending on the amount of income recognized under the different methods.

A taxpayer can avoid an AMT adjustment on long-term contracts by using the percentage of completion method for regular income tax purposes rather than the completed contract method.

Adjusted Gain or Loss

When property is sold during the year or a casualty occurs to business or income-producing property, gain or loss reported for regular income tax may be different than gain or loss determined for the AMT. This difference occurs because the

[27]Class lives and recovery periods are established for all assets in Rev.Proc. 87–56, 1987–2 C.B. 674.

[28]§ 56(a)(5).

[29]§ 56(a)(3).

[30]See Chapter 18 of *South-Western Federal Taxation: Individual Income Taxes* for a detailed discussion of the completed contract and percentage of completion methods of accounting.

[31]§ 56(a)(3).

adjusted basis of the property for AMT purposes must reflect any current and prior AMT adjustments for the following.[32]

- Depreciation.
- Circulation expenditures.
- Amortization of certified pollution control facilities.

A negative gain or loss adjustment is required if:

- the gain for AMT purposes is less than the gain for regular income tax purposes;
- the loss for AMT purposes is more than the loss for regular income tax purposes; or
- a loss is computed for AMT purposes and a gain is computed for regular income tax purposes.

Otherwise, the AMT gain or loss adjustment is positive.

EXAMPLE 11

In January 1998, Cardinal Corporation paid $100,000 for a duplex acquired for rental purposes. Regular income tax depreciation, AMT depreciation, and the AMT adjustment are as follows:

	Depreciation		
Year	Regular Income Tax	AMT	AMT Adjustment
1998	$3,485[1]	$2,396[2]	$1,089
1999	3,636[3]	2,500[4]	1,136
2000	3,636	2,500	1,136
2001	3,636	2,500	1,136
2002	3,636	2,500	1,136
2003	3,636	2,500	1,136
2004	3,636	2,500	1,136
2005	3,636	2,500	1,136
2006	3,636	2,500	1,136
2007	3,636	2,500	1,136
2008	3,636	2,500	1,136
2009	3,636	2,500	1,136

[1] $100,000 cost × 3.485% (Table 5.3) = $3,485
[2] $100,000 cost × 2.396% (Table 5.7) = $2,396
[3] $100,000 cost × 3.636% (Table 5.3) = $3,636
[4] $100,000 cost × 2.500% (Table 5.7) = $2,500

Cardinal then sold the duplex on December 20, 2010, for $105,000. Regular income tax depreciation for 2010 is $3,485 [($100,000 cost × 3.636% from Table 5.3) × (11.5/12)]. AMT depreciation for 2010 is $2,396 [($100,000 cost × 2.500% from Table 5.7) × (11.5/12)]. Cardinal's positive AMT adjustment for 2010 is $1,089 ($3,485 regular income tax depreciation − $2,396 AMT depreciation).

Because depreciation on the duplex differs for regular income tax and AMT purposes, Cardinal's adjusted basis for the property is different for regular income tax and AMT purposes. Consequently, the gain or loss on disposition of the duplex is different for regular income tax and AMT purposes.

The adjusted basis for Cardinal's duplex is $53,034 for regular income tax purposes and $67,708 for AMT purposes.

[32] § 56(a)(6).

	Regular Income Tax	AMT
Cost	$100,000	$100,000
Depreciation:		
1998	(3,485)	(2,396)
1999	(3,636)	(2,500)
2000	(3,636)	(2,500)
2001	(3,636)	(2,500)
2002	(3,636)	(2,500)
2003	(3,636)	(2,500)
2004	(3,636)	(2,500)
2005	(3,636)	(2,500)
2006	(3,636)	(2,500)
2007	(3,636)	(2,500)
2008	(3,636)	(2,500)
2009	(3,636)	(2,500)
2010	(3,485)	(2,396)
Adjusted basis	$ 53,034	$ 67,708

The regular income tax gain is $51,966 and the AMT gain is $37,292.

	Regular Income Tax	AMT
Amount realized	$105,000	$105,000
Adjusted basis	(53,034)	(67,708)
Recognized gain	$ 51,966	$ 37,292

Because the regular income tax and AMT gain on the sale of the duplex differ, Cardinal makes a negative AMT adjustment of $14,674 ($51,966 regular income tax gain − $37,292 AMT gain). The negative adjustment matches the $14,674 total of the 13 positive adjustments for depreciation ($1,089 in 1998 + $1,136 in 1999 + $1,136 in 2000 + $1,136 in 2001 + $1,136 in 2002 + $1,136 in 2003 + $1,136 in 2004 + $1,136 in 2005 + $1,136 in 2006 + $1,136 in 2007 + $1,136 in 2008 + $1,136 in 2009 + $1,089 in 2010). ■

Passive Activity Losses

Net losses on passive activities are not deductible in computing either the regular income tax or the AMT for closely held C corporations (cannot offset portfolio income) and personal service corporations (cannot offset either active income or portfolio income).[33] This does not, however, eliminate the possibility of adjustments attributable to passive activities.

The rules for computing taxable income differ from the rules for computing AMTI. It follows, then, that the rules for computing a loss for regular income tax purposes differ from the AMT rules for computing a loss. Therefore, any *passive loss* computed for regular income tax purposes may differ from the passive loss computed for AMT purposes.

Robin, Inc., a personal service corporation, acquired two passive activities in 2010. Robin received net passive income of $10,000 from Activity A and had no AMT adjustments or preferences in connection with the activity. Activity B had gross income of

[33] § 469(a).

$27,000 and operating expenses (not affected by AMT adjustments or preferences) of $19,000. Robin claimed MACRS depreciation of $20,000 for Activity B; depreciation under the ADS would have been $15,000. In addition, Robin deducted $10,000 of percentage depletion in excess of basis. The following comparison illustrates the differences in the computation of the passive loss for regular income tax and AMT purposes for Activity B.

	Regular Income Tax	AMT
Gross income	$ 27,000	$ 27,000
Deductions:		
Operating expenses	($ 19,000)	($ 19,000)
Depreciation	(20,000)	(15,000)
Depletion	(10,000)	–0–
Total deductions	($ 49,000)	($ 34,000)
Passive loss	($ 22,000)	($ 7,000)

Because the adjustment for depreciation ($5,000) applies and the preference for depletion ($10,000) is not taken into account in computing AMTI, the regular income tax passive activity loss of $22,000 for Activity B is reduced by these amounts, resulting in a passive activity loss of $7,000 for AMT purposes.

For regular income tax purposes, Robin would offset the $10,000 of net passive income from Activity A with $10,000 of the passive loss from Activity B. For AMT purposes, the corporation would offset the $10,000 of net passive income from Activity A with the $7,000 passive activity loss allowed from Activity B, resulting in passive activity income of $3,000. Thus, in computing AMTI, Robin makes a positive passive loss adjustment of $3,000 [$10,000 (passive activity loss allowed for regular income tax) – $7,000 (passive activity loss allowed for the AMT)].[34]

For regular income tax purposes, Robin, Inc., has a suspended passive loss of $12,000 [$22,000 (amount of loss) – $10,000 (used in 2010)]. This suspended passive loss can offset passive income in the future or can offset active or portfolio income when the corporation disposes of the loss activity (refer to Chapter 6). For AMT purposes, Robin's suspended passive loss is $0 [$7,000 (amount of loss) – $7,000 (amount used in 2010)]. ■

Tax Planning Strategies — Avoiding Preferences and Adjustments

FRAMEWORK FOCUS: TAX RATE

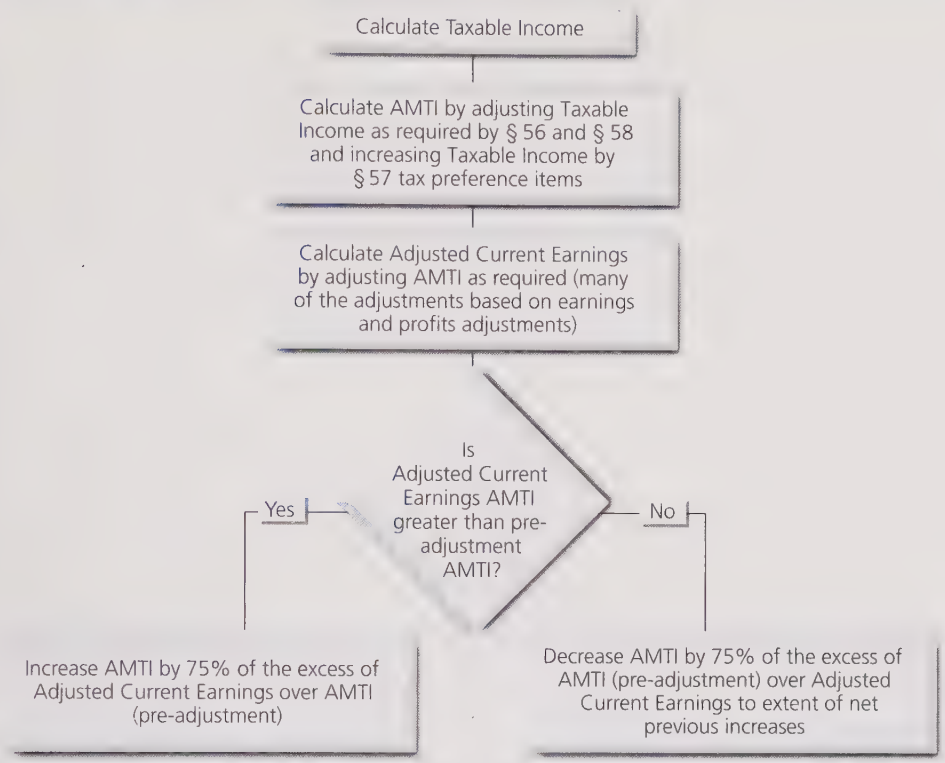
Strategy: Control the Character of Income and Deductions.

Investments in state and local bonds are attractive for income tax purposes because the interest is not included in gross income. Some of these bonds (most private activity bonds) are issued to generate funds that are not used for an essential function of the government (e.g., to provide infrastructure for shopping malls or industrial parks or to build sports facilities). The interest on such bonds is a tax preference item (except for private activity bonds issued after 2008 and before 2011) and could lead to the imposition of the AMT. When the AMT applies, an investment in regular tax-exempt bonds or even fully taxed private-sector bonds might yield a higher after-tax rate of return.

For a corporation anticipating AMT problems, capitalizing rather than expensing certain costs can avoid generating preferences and adjustments. The decision should be based on the present discounted value of after-tax cash flows under the available alternatives. Costs that may be capitalized and amortized, rather than expensed, include circulation expenditures, mining exploration and development costs, and research and experimentation expenditures.

[34] The depreciation adjustment and depletion preference are combined as part of the passive loss adjustment and are *not* reported separately.

FIGURE 14.1 Determining the ACE Adjustment*



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ADJUSTED CURRENT EARNINGS (ACE)

LO.6
Understand the function of adjusted current earnings (ACE).

The **adjusted current earnings (ACE)** rules make up a third, separate tax system, parallel to both AMT and taxable income. S corporations, real estate investment trusts, regulated investment companies, and real estate mortgage investment conduits are not subject to the ACE provisions.

The purpose of the ACE adjustment is to ensure that the mismatching of financial statement income and taxable income will not produce inequitable results. ACE represents another attempt by Congress to assure that large corporations with significant financial accounting income pay a fair share of Federal corporate income tax.

The ACE adjustment is tax-based and can be negative or positive. AMTI is increased by 75 percent of the excess of ACE over unadjusted AMTI, or AMTI is reduced by 75 percent of the excess of unadjusted AMTI over ACE. Any negative ACE adjustment is limited to the aggregate of the positive adjustments under ACE for prior years reduced by the previously claimed negative adjustments (see Figure 14.1).[35] Any unused negative adjustment is lost forever.

EXAMPLE 19

A calendar year corporation reports the following.

	2009	2010	2011
Unadjusted AMTI	$3,000,000	$3,000,000	$3,100,000
Adjusted current earnings	4,000,000	3,000,000	2,000,000

[35] §§ 56(g)(1) and (2). *Unadjusted AMTI* is AMTI before the ACE adjustment and the AMT NOL deduction.

CONCEPT SUMMARY 14.2

Impact of Various Transactions on ACE and E & P

	Effect on Unadjusted AMTI in Arriving at ACE	Effect on Taxable Income in Arriving at Corporate E & P
Tax-exempt income (net of expenses)	Add	Add
Federal income tax	No effect	Subtract
Dividends received deduction (80% and 100% rules)	No effect	Add
Dividends received deduction (70% rule)	Add	Add
Exemption amount ($40,000)	No effect	No effect
Key employee insurance proceeds	Add	Add
Excess charitable contribution	No effect	Subtract
Excess capital losses	No effect	Subtract
Disallowed meals and entertainment expenses	No effect	Subtract
Penalties and fines	No effect	Subtract
Intangible drilling costs deducted currently	Add	Add
Deferred gain on installment sales	Add	Add
Realized (not recognized) gain (e.g., involuntary conversion, like-kind exchanges)	No effect	No effect
Loss on sale between related parties	No effect	Subtract
Premiums paid on key employee life insurance	Subtract	Subtract
Cash surrender value increase on life insurance policy	Add	Add
Organization expense amortization	Add	Add

In 2009, since ACE exceeds unadjusted AMTI by $1 million, $750,000 (75% × $1,000,000) is the positive ACE adjustment. No adjustment is necessary for 2010. Unadjusted AMTI exceeds ACE by $1,100,000 in 2011, so there is a potential negative ACE adjustment of $825,000. Since the total increases to AMTI for prior years equal $750,000 (and there are no negative adjustments), only $750,000 of the potential negative ACE adjustment reduces AMTI for 2011. Further, $75,000 of negative ACE is lost forever. ■

The starting point for computing ACE is AMTI, which is regular taxable income after AMT adjustments (other than the NOL and ACE adjustments) and tax preferences.[36] Pre-NOL AMTI is adjusted for certain items to determine ACE. See Concept Summary 14.2.

DIGGING DEEPER 6

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[36] § 56(g)(3).

Crimson Corporation makes the ACE adjustment calculation as follows.

AMTI		$ 5,780,000
Plus:		
Municipal bond interest	$210,000	
Installment gain	140,000	
70% dividends received deduction	300,000	
Income element in cash surrender life insurance	60,000	
Organization expense amortization	70,000	780,000
Subtotal		$ 6,560,000
Less:		
Life insurance premiums paid	$240,000	(240,000)
Adjusted current earnings		$ 6,320,000
AMTI		(5,780,000)
Base amount		$ 540,000
Times		.75
ACE adjustment (positive)		$ 405,000

ACE should not be confused with current E & P. Many items are treated in the same manner, but certain items that are deductible in computing E & P (but are not deductible in calculating taxable income) generally are not deductible in computing ACE (e.g., Federal income taxes). Concept Summary 14.2 compares the impact various transactions will have on the determination of ACE and E & P.

COMPUTING ALTERNATIVE MINIMUM TAXABLE INCOME

LO.7
Compute the AMT liability for corporations.

The following example illustrates the effect of tax preferences and adjustments in arriving at AMTI.

Tan Corporation (a calendar year company) had the following transactions.

Taxable income	$4,250,000
Income deferred by using completed contract method (versus percentage of completion method)	450,000
Percentage depletion claimed (the property has a zero adjusted basis)	1,575,000
Interest on City of Elmira (Michigan) 2007 private activity bonds	1,175,000

Tan Corporation's AMTI is determined as follows.

Taxable income		$4,250,000
Adjustments		
Income deferred by using completed contract method (versus percentage of completion method)		450,000
Tax preferences		
Excess depletion deduction	$1,575,000	
Interest on private activity municipal bonds	1,175,000	2,750,000
AMTI		$7,450,000

Tax Planning Strategies OPTIMUM USE OF THE AMT AND REGULAR CORPORATE INCOME TAX RATE DIFFERENCE

FRAMEWORK FOCUS: TAX RATE

Strategy: Shift Net Income from High-Bracket Years to Low-Bracket Years.

A corporation that cannot avoid the AMT in a particular year often can save taxes by taking advantage of the difference between the AMT and the regular income tax rates. In general, a corporation that expects to be subject to the AMT should consider accelerating income and deferring deductions for the remainder of the year. Since the difference between the regular income tax rate and the AMT rate may be as much as 14 or 15 percentage points, this strategy may result in the income being taxed at less than it would be if reported in the next year (a non-AMT year). If the same corporation expects to be subject to the AMT for the next year (or years) and is not subject to AMT this year, this technique should be reversed.

EXAMPLE 29

Falcon Corporation expects to be in the 34% regular income tax bracket in 2011, but is subject to the AMT in 2010. In late 2010, Falcon is contemplating selling a tract of unimproved land (basis of $200,000 and fair market value of $1 million), which is classified as inventory. Under these circumstances, it may be preferable to sell the land in 2010. The gain of $800,000 ($1,000,000 − $200,000) generates a tax of $160,000 [$800,000 (recognized gain) × 20% (AMT rate)]. However, if the land is sold in 2011, the resulting tax is $272,000 [$800,000 (recognized gain) × 34% (regular corporate income tax rate)]. A nominal savings of $112,000 ($272,000 − $160,000) materializes by making the sale in 2010. ■

Whenever one accelerates income or defers deductions, a present value analysis should be conducted. This technique to accelerate gross income is attractive only if it reduces the present value of tax liabilities.

AMT RATE AND EXEMPTION

The AMT rate is 20 percent. The rate is applied to the *AMT base*, which is AMTI reduced by the *AMT exemption*. The exemption amount for a corporation is $40,000 reduced by 25 percent of the amount by which AMTI exceeds $150,000. The exemption phases out entirely when AMTI reaches $310,000.

Tax Planning Strategies CONTROLLING THE TIMING OF PREFERENCES AND ADJUSTMENTS

FRAMEWORK FOCUS: TAX RATE

Strategy: Control the Character of Income and Deductions.

In many situations, corporations with modest levels of income may be able to avoid the AMT by making use of the exemption. To maximize the exemption, taxpayers should attempt to avoid bunching positive adjustments and tax preferences in any one year. Rather, net these items against negative adjustments to keep AMTI low. When the expenditure is largely within the control of the taxpayer, timing to avoid bunching is more easily accomplished.

EXAMPLE 30

Beige Corporation has AMTI of $180,000. Since the exemption amount is reduced by $7,500 [25% × ($180,000 − $150,000)], the amount remaining is $32,500 ($40,000 − $7,500). Thus, Beige Corporation's alternative minimum tax base (refer to Exhibit 14.2) is $147,500 ($180,000 − $32,500). ■

MINIMUM TAX CREDIT

The **minimum tax credit** acts to make the AMT merely a *prepayment of tax* for corporations. Essentially, the AMT paid in one tax year may be carried forward indefinitely and used as a credit against the corporation's future *regular* tax liability that exceeds

its tentative minimum tax. The minimum tax credit may not be carried back and may not be offset against any future AMT liability.

EXAMPLE 28

Return to the facts of Example 26. AMTI exceeds $310,000, so there is no exemption amount. The tentative minimum tax is $1,490,000 (20% of $7,450,000). Since Tan's regular income tax liability for 2010 is $1,445,000, the AMT liability is $45,000 ($1,490,000 – $1,445,000). The minimum tax credit carried forward is $45,000, the current year's AMT. The credit can be used to reduce regular income tax liability in future years (but not below the tentative alternative minimum tax). ■

OTHER ASPECTS OF THE AMT

In addition to paying their regular income tax liability, corporations must make estimated tax payments of the AMT liability. Even corporations that prepare quarterly financial statements may find this requirement adds to compliance costs.

Tax Planning Strategies THE S CORPORATION OPTION

FRAMEWORK FOCUS: TAX RATE

Strategy: Avoid Double Taxation.

Corporations that make the S election are not subject to the corporate AMT. As noted in Chapter 12, however, various AMT adjustments and preferences pass through to the individual shareholders. But one troublesome adjustment, the one involving the ACE adjustment, is avoided since it does not apply to individual taxpayers.

The only credit that can be used to offset the AMT is the foreign tax credit (FTC). The general business credit and other credits discussed earlier in the chapter are unavailable in AMT years.

The corporate AMT is computed and reported by completing Form 4626.

14.4 INDIVIDUAL ALTERNATIVE MINIMUM TAX

The AMT applicable to individuals is similar to the corporate AMT. Most of the adjustments and preferences discussed above apply equally to individuals and corporations. However, there are several important differences.

- The individual AMT rate is slightly progressive, with rates at 26 percent on the first $175,000 of AMTI and at 28 percent on any additional AMTI.
- The alternative rate on net capital gain of 0 or 15 percent applies.
- The AMT exemption and phaseout amounts are tied to the individual's filing status for the year. The exemption phases out at a rate of $1 for every $4 of AMTI.[37]

Filing Status	Initial Exemption Amount in 2009	Phaseout Range	
		Begins at	Ends at
Married, joint	$70,950	$150,000	$433,800
Married, separate	35,475	75,000	216,900
Single, head of household	46,700	112,500	299,300

- Individuals make no AMT adjustment for ACE.

[37]At the time of this writing, Congress had not provided the 2010 AMT exclusion amounts. Calculations here and in the Problem Materials use the 2009 amounts.

IS A NEW VERSION OF THE AMT NEEDED?

Nearly all of the discussion regarding the AMT relates to reducing the number of taxpayers projected to be subject to its reach in the future (i.e., 33 million in 2010). A look at IRS statistics, however, suggests that perhaps the AMT needs to be revised to "catch" certain taxpayers.

In 2005, 7,400 individual taxpayers with AGI of at least $200,000 paid no Federal income tax (i.e., neither the regular income tax nor the AMT). This is an interesting statistic, considering that the original AMT came about in 1969 because only 155 wealthy taxpayers had no tax liability.

The $0 tax liabilities in 2005 may not be as bad as they first appear, however. A number of those 7,400 individuals paid no Federal income tax as a result of the increase in the AGI limit on charitable contributions to 100 percent because of Hurricane Katrina.

- Some additional adjustments apply to individual taxpayers. Taxes and miscellaneous itemized deductions subject to the 2 percent-of-AGI floor are not allowed as deductions for AMTI. Medical expenses are allowed only to the extent that they exceed 10 percent of AGI (instead of a 7.5 percent limitation for regular income tax purposes). Interest expense deductions are limited to qualified residence interest, interest on certain student loans, and investment interest (subject to limitations). Finally, the standard deduction and personal and dependency exemptions are not allowed as deductions when computing AMTI. Other individual-specific adjustments also exist, including an adjustment accelerating the taxation of incentive stock options.
- Determination of the minimum tax credit is more complex for individual taxpayers. The credit usually applies only to AMT generated as a result of *timing* differences.

For 2007, 85 percent of the AMT revenue collected from individual taxpayers resulted from two source—deductions for state and local taxes, and personal and dependency exemptions.

Although there are several computational differences, the individual AMT and the corporate AMT have the same objective: to force taxpayers who have more economic income than that reflected in taxable income to pay a fair share of Federal income tax.

REFOCUS ON THE BIG PICTURE

DEALING WITH TAX CREDITS AND THE AMT

Tax credits are used by the Federal government to promote certain social and economic objectives. Credits are dollar-for-dollar reductions in tax liability. While tax credits may have strict qualification requirements, taking advantage of available credits may significantly reduce a business's tax liability. Progress Corporation may qualify for a 20 percent tax credit for rehabilitating a certified historic structure. In addition, if Mike hires workers from economically disadvantaged groups, the company may qualify for work opportunity tax credits. The company also may qualify for a generous credit for employer-provided child care, equal to 25 percent of qualified child care expenses. Mike and his CPA might also want to explore taking advantage of the disabled access credit, which is designed to encourage small businesses to make their facilities accessible to disabled individuals.

What If?

Mike has heard horror stories about the alternative minimum tax (AMT) and is concerned about its potential impact on his company. What if Mike's company is subject to the AMT?

CONTINUED

If Progress Corporation is subject to the AMT, the company's general business credits (including the tax credit for rehabilitation expenditures, the work opportunity tax credit, the disabled access credit, and the credit for employer-provided child care) are limited to the taxpayer's regular income tax reduced by the greater of the company's tentative minimum tax or 25 percent of the regular income tax liability exceeding $25,000. Accordingly, much of the tax benefit may be lost or require a carryback or carryover to another tax year. However, small corporations with average gross receipts under certain thresholds may be exempt from the AMT. Before Mike proceeds with his plans, his exposure to the AMT should be determined.

SUGGESTED READINGS

Albert B. Ellentuck, "Case Study: Avoiding the AMT Depreciation Adjustment," *The Tax Adviser*, January 2003.

Larry R. Garrison,"New Law Creates, Expands, and Extends Energy-Related Tax Incentives," *Practical Tax Strategies*, December 2008.

Beth Henricks,"Enlist Human Resources to Screen for Employment Tax Credits," *Practical Tax Strategies*, April 2008.

Christine Kachinsky, France Leibsker, and David Culp, "New Tax Act Extends the Research Credit Retroactively (Again) and Adds Some Enhancements," *Journal of Taxation*, March 2007.

John Malloy, Craig Langstraat, and Thresi E. Ramapuram, "New Law Offers AMT Relief When Incentive Stock Options Produce Loss," *Practical Tax Strategies*, April 2009.

James P. Trebby and George W. Kutner, "Seek Ways to Minimize the Mushrooming Alternative Minimum Tax," *Practical Tax Strategies*, June 2005.

KEY TERMS

Adjusted current earnings (ACE), 14–25

Alternative minimum tax (AMT), 14–13

Alternative minimum taxable income (AMTI), 14–15

Credit for employer-provided child care, 14–12

Credit for small employer pension plan startup costs, 14–11

Disabled access credit, 14–10

Energy credits, 14–10

Foreign tax credit (FTC), 14–12

General business credit, 14–3

Minimum tax credit, 14–28

Private activity bonds, 14–18

Rehabilitation expenditures credit, 14–5

Rehabilitation expenditures credit recapture, 14–6

Research activities credit, 14–8

Tax credits, 14–2

Tax preference items, 14–16

Work opportunity tax credit, 14–7

PROBLEMS

1. **LO.2** Connie has a tentative general business credit of $42,000 for the current year. Her net regular tax liability before the general business credit is $107,000, and her tentative minimum tax is $88,000. Compute Connie's allowable general business credit for the year.

2. **LO.2** Spruce Corporation holds the following general business credit carryovers.

2006	$ 5,000
2007	15,000
2008	5,000
2009	20,000
Total carryovers	$45,000

c. Draft a letter to Helen Carlon, Grackle's controller, regarding the choice of depreciation methods. Helen's address is 500 Monticello Avenue, Glendale, AZ 85306.

15. **LO.5** Josepi's construction company uses the completed contract method. During the three-year period 2010–2012, Josepi recognized the following income on his two construction contracts.

Year	Contract 1	Contract 2
2010	$700,000*	$ –0–
2011	–0–	–0–
2012	–0–	800,000**

*Construction completed in 2010.

**Construction completed in 2012.

If Josepi had used the percentage of completion method, he would have recognized the following income.

Year	Contract 1	Contract 2
2010	$40,000	$275,000
2011	–0–	225,000
2012	–0–	300,000

Calculate the AMT adjustment for 2010, 2011, and 2012.

ETHICS AND EQUITY

16. **LO.5** Allie, who was an accounting major in college, is the controller of a medium-size construction corporation. She prepares the corporate tax return each year. Due to reporting a home construction contract using the completed contract method, the corporation is subject to the AMT in 2010. Allie files the 2010 corporate tax return in early February 2011. The total tax liability is $58,000 ($53,000 regular income tax liability + $5,000 AMT).

In early March, Allie reads an article on minimizing income taxes. Based on this article, she decides that it would be beneficial for the corporation to report the home construction contract using the percentage of completion method on its 2010 return. Although this will increase the corporation's 2010 income tax liability, it will minimize the total income tax liability over the two-year construction period. Therefore, Allie files an amended return on March 14, 2011. Evaluate Allie's actions from both a tax avoidance and an ethical perspective.

17. **LO.5** Buford sells an apartment building for $720,000. His adjusted basis is $500,000 for regular income tax purposes and $550,000 for AMT purposes. Calculate Buford's:
a. Gain for regular income tax purposes.
b. Gain for AMT purposes.
c. AMT adjustment, if any.

ISSUE ID

18. **LO.5** Pheasant, Inc., is going to be subject to the AMT in 2010. The corporation owns an investment building and is considering disposing of it and investing in other realty. Based on an appraisal of the building's value, the realized gain would be $85,000. Ed has offered to purchase the building from Pheasant with the closing date being December 29, 2010. Ed wants to close the transaction in 2010 because certain beneficial tax consequences will result only if the transaction is closed prior to the beginning of 2011. Abby has offered to purchase the building with the closing date being January 2, 2011. The building has a $95,000 greater AMT adjusted basis. For regular income tax purposes, Pheasant expects to be in the 34% tax bracket. What are the relevant tax issues that Pheasant faces in making its decision?

19. **LO.5** Flicker, Inc., a closely held corporation, acquired a passive activity in 2010. Gross income from operations of the activity was $160,000. Operating expenses, not including depreciation, were $122,000. Regular income tax depreciation of $49,750 was computed under MACRS. AMT depreciation, computed under ADS, was $41,000. Compute Flicker's passive loss deduction and passive loss suspended for regular income tax purposes and for AMT purposes.

20. **LO.6** Maize Corporation (a calendar year corporation) reports the following information for the years listed.

	2009	2010	2011
Adjusted current earnings	$5,000,000	$5,000,000	$7,000,000
Unadjusted AMTI	8,000,000	5,000,000	3,000,000

Compute the ACE adjustment for each year.

21. **LO.6** Based upon the following facts, calculate adjusted current earnings (ACE).

Alternative minimum taxable income (AMTI)	$5,120,000
Municipal bond interest	630,000
Expenses related to municipal bonds	50,000
Key employee life insurance proceeds in excess of cash surrender value	2,000,000
Organization expense amortization	100,000
Cost of goods sold	6,220,000
Advertising expenses	760,000
Loss between related parties	260,000
Life insurance premiums paid	300,000

22. **LO.6** Purple Corporation, a calendar year taxpayer, reported the following amounts. Calculate Purple's positive and negative ACE adjustments.

	Preadjusted AMTI	ACE
2008	$85,000,000	$70,000,000
2009	70,000,000	90,000,000
2010	54,000,000	40,000,000
2011	60,000,000	20,000,000

23. **LO.4, 5** Determine whether each of the following transactions is a preference (P), an adjustment (A), or not applicable (NA) for purposes of the corporate AMT.
    a. Depletion in excess of basis taken by Giant Oil Company.
    b. Accelerated depreciation on property.
    c. Charitable contributions of cash.
    d. Adjusted current earnings.
    e. Untaxed appreciation on property donated to charity.
    f. Dividends received deduction.

24. **LO.7** In each of the following *independent* situations, determine the tentative minimum tax. Assume the company is not in small corporation status.

	AMTI (Before the Exemption Amount)
Quincy Corporation	$150,000
Redland Corporation	160,000
Tanzen Corporation	320,000

25. **LO.7** For 2010, Peach Corporation (a calendar year company) had the following transactions.

Taxable income	$5,000,000
Regular tax depreciation on realty in excess of ADS (placed in service in 1990)	1,700,000
Amortization of certified pollution control facilities (in excess of ADS amortization)	200,000
Tax-exempt interest on private activity bonds issued in 2006	300,000
Percentage depletion in excess of the property's adjusted basis	700,000

a. Determine Peach Corporation's AMTI.
b. Determine the alternative minimum tax base (refer to Exhibit 14.2).
c. Determine the tentative minimum tax.
d. What is the amount of the AMT?

26. **LO.7** Included in Alice's regular taxable income and in her AMT base is a $300,000 capital gain on the sale of stocks that she owned for three years. Alice is in the 35% tax bracket for regular income tax purposes. In calculating her regular income tax liability, she uses the appropriate alternative tax rate on net capital gain of 15%.
a. What rate should Alice use in calculating her tentative AMT?
b. What is Alice's AMT adjustment?
c. How would your answers in (a) and (b) change if the taxpayer were a C corporation in the 34% tax bracket for regular income tax purposes?

CRITICAL THINKING

27. **LO.4, 5** Calculate the AMT for the following cases in 2010. The individual taxpayer reports regular taxable income of $450,000 and no tax credits.

	Tentative AMT	
Filing Status	Case 1	Case 2
Single	$200,000	$180,000
Married, filing jointly	200,000	180,000

CRITICAL THINKING

28. **LO.7** Grayson, who is single with no dependents and does not itemize, provides you with the following information for 2010.

Short-term capital loss	$ 4,000
Long-term capital gain	19,000
Municipal bond interest received on private activity bonds acquired in 1996	17,000
Dividends from IBM	6,500
Excess of FMV over cost for incentive stock options (the rights became freely transferable and not subject to a substantial risk of forfeiture in 2010)	40,000
Charitable contributions	10,000
Qualified residence interest	9,000

What are Grayson's tax preference items and AMT adjustments for 2010?



1. Balm, Inc., has a general business credit for 2010 of $90,000. Balm's regular income tax liability before credits is $140,000, and its tentative AMT is $132,000.
   a. Calculate the amount of general business credit that Balm can use in 2010 and calculate its general business credit carryback and carryforward, if any.
   b. Balm projects a $140,000 regular 2011 income tax liability. Its tentative AMT will be $132,000. Balm is considering making an investment early in 2011 that annually will produce $45,000 of tax-exempt income. Balm is trying to decide between two alternatives. The first alternative is a tax-exempt bond that is a 2000 private activity bond. The second alternative is a tax-exempt bond that is not a private activity bond. Advise Balm on the preferable investment.

2. Cooper Partnership, a calendar year partnership, made qualifying rehabilitation expenditures to a building that it has used in its business for eight years. These improvements were placed in service on January 5, 2009. The amount of the rehabilitation expenditures credit was $40,000.

   Cooper is negotiating to sell the building in either December 2010 or January 2011. The sales price will be $600,000, and the recognized gain will be $100,000. Provide support for the CFO's position that Cooper should delay the sale until 2011.

3. For many years, Saul's sole proprietorship and his related Form 1040 have had a number of AMT tax preferences and AMT adjustments. He has made the AMT calculation each year, but the calculated amount always has been $0. Saul's regular taxable income and the AMT adjustments and preferences for 2010 are the same as for last year. Yet he must pay AMT this year. Explain how this could happen.

RESEARCH PROBLEMS

Note: Solutions to Research Problems can be prepared by using the **Checkpoint® Student Edition** online research product, which is available to accompany this text. It is also possible to prepare solutions to the Research Problems by using tax research materials found in a standard tax library.

THOMSON REUTERS
Checkpoint® Student Edition

Research Problem 1. Miriam, an admirer of early twentieth-century architecture, discovers a 1920s-era house in the countryside outside Mobile, Alabama, during a recent Sunday excursion. She desires not only to purchase and renovate this particular house, but also to move the structure into Mobile so her community can enjoy its architectural features.

Being aware of the availability of the tax credit for rehabilitation expenditures, she wishes to maximize her use of the provision, if it is available in this case, once the renovation work begins in Mobile. However, Miriam also informs you that she will pursue the purchase, relocation, and renovation of the house only if the tax credit is available.

Comment on Miriam's decision and whether any renovation expenditures incurred will qualify for the tax credit for rehabilitation expenditures.

Partial list of research aids:
George S. Nalle III v. Comm., 72 AFTR 2d 93-5705, 997 F.2d 1134, 93-2 USTC ¶50,468 (CA-5, 1993).

Research Problem 2. Oriole Corporation is a large wholesaler of office products. To remain successful in a fiercely competitive industry, Oriole has automated and computerized many of its business operations. Specifically, the corporation has developed several new software programs to:

COMMUNICATIONS

- Maintain files of customer histories.
- Create a paperless invoicing system.
- Develop a computer-to-computer order entry system.
- Monitor inventory levels more closely.

Oriole estimates that it spent more than $1 million to develop and test the new software programs that are used throughout the business. To date, Oriole has not sold the software programs to the public, but it is contemplating doing so. Oriole has claimed a research and experimentation deduction for the costs associated with developing the software programs. The corporation also wants to claim the research activities credit relating to the software development. Can Oriole do so? Write a memo to the tax research file summarizing your conclusions.

Research Problem 3. Your ophthalmologist, Dr. Hunter Francis (55 Wheatland Drive, Hampton, CT 06247), has been very pleased with the growth of his practice in the 15 years he has been in business. This growth has resulted, at least in part, because he has aggressively marketed his services and tried to accommodate clients with various needs. This year Dr. Francis purchased a sophisticated piece of equipment that enables him to diagnose persons with mental handicaps, hearing impairments, and physical disabilities without having to go through a series of questions. In addition, he can treat his patients who are not disabled much more accurately and efficiently by using this equipment.

COMMUNICATIONS

Since purchasing the machine this year for $9,500, Dr. Francis has used it on many occasions. Unfortunately, he has not been able to attract any disabled patients, even though previously he referred such people to other ophthalmologists who owned the necessary equipment. Therefore, the primary purpose for acquiring the equipment (i.e., to attract disabled patients) has not been realized, but he has put it to good use in treating other patients. Write a letter to Dr. Francis explaining whether he may claim the disabled access credit for this acquisition.

Research Problem 4. Parrot, Inc., receives tax-exempt interest of $20,000 on bonds that are classified as private activity bonds. The bonds were issued in 2007. The corporation appropriately excludes the $20,000 from its gross income for regular income tax purposes under § 103(a) and § 103(b)(1). Parrot has asked you for advice on the treatment of the $20,000 for AMT purposes. Find the Code Section that addresses the AMT treatment for private activity bond interest. Provide Parrot with the advice it has requested.

Research Problem 5. Teal, Inc., owns two warehouses that were placed in service before 1987. Accelerated depreciation for 2010 on Warehouse A is $36,000 (straight-line depreciation

would have been $30,000). On Warehouse B, accelerated depreciation was $16,000 (straight-line depreciation would have been $20,000). What is the amount of Teal's tax preference for excess depreciation in 2010?



Use the tax resources of the Internet to address the following questions. Do not restrict your search to the Web, but include a review of newsgroups and general reference materials, practitioner sites and resources, primary sources of the tax law, chat rooms and discussion groups, and other opportunities.

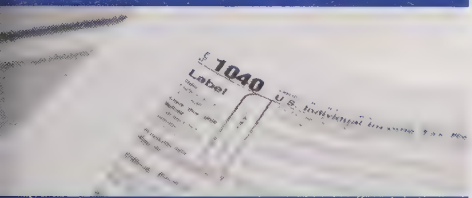
Research Problem 6. The foreign tax credit is especially valuable when a U.S. business earns income in a country whose income tax rates exceed those of the United States. List five countries whose tax rates on business income exceed those of the United States, and five where the corresponding U.S. rates are higher.

Research Problem 7. Some parties believe that many corporations are paying little, if any, corporate income tax and blame the AMT for being ineffective. Examine both government and press sites on the Internet and summarize these complaints.

Research Problem 8. Ascertain if your state's income tax has an AMT component. If your state does not levy an income tax, choose a contiguous state that does. List the AMT tax rate for corporations, and describe if or how the AMT tax base follows Federal AMTI.

CHAPTER 15

Comparative Forms of Doing Business



LEARNING OBJECTIVES

After completing Chapter 15, you should be able to:

LO.1 Identify the principal **legal and tax forms for conducting a business.** **(pp. 15-3 to 15-5)**

LO.2 Include **nontax factors** in business decisions. **(pp.15-5 to 15-7)**

LO.3 Distinguish between the forms for conducting a business according to whether they are subject to single taxation or **double taxation.** **(pp. 15-7 to 15-10)**

LO.4 Identify techniques for **avoiding double taxation.** **(pp.15-11 to 15-15)**

LO.5 Understand and apply the **conduit and entity concepts** as they affect operations, capital changes, and distributions. **(pp.15-15 to 15-21)**

LO.6 Analyze the effects of the **disposition of a business** on the owners and the entity for each of the forms for conducting a business. **(pp.15-21 to 15-26)**

LO.7 Compare the **tax consequences** of the most common legal forms of doing business. **(pp.15-27 to 15-30)**

TAX *Talk*

[My law firm] had a rule—at least it seemed to be a rule—that everybody that came had to spend at least a year working on taxes. The general rationale for the rule as I could understand it was that taxes were so important to everything that you do, whatever the kind of case you are handling, you have to know something about the tax consequences of things.

—Charles A. Horsky

OUTLINE

15.1 Forms of Doing Business, 15-3
Principal Forms, 15-3
Limited Liability Companies, 15-4
15.2 Nontax Factors, 15-5
Capital Formation, 15-5
Limited Liability, 15-6
Other Factors, 15-7
15.3 Single versus Double Taxation, 15-7
Overall Impact on Entity and Owners, 15-7
Alternative Minimum Tax, 15-9
State Taxation, 15-10
15.4 Minimizing Double Taxation, 15-11
Making Deductible Distributions, 15-11
Not Making Distributions, 15-12
Return of Capital Distributions, 15-13
Electing S Corporation Status, 15-14
15.5 Conduit versus Entity Treatment, 15-15
Effect on Recognition at Time of Contribution to the Entity, 15-15
Effect on Basis of Ownership Interest, 15-16
Effect on Results of Operations, 15-17
Effect on Recognition at Time of Distribution, 15-18
Effect on Passive Activity Losses, 15-19
Effect of At-Risk Rules, 15-19
Effect of Special Allocations, 15-20
15.6 Disposition of a Business or an Ownership Interest, 15-21
Sole Proprietorships, 15-22
Partnerships and Limited Liability Entities, 15-23
C Corporations, 15-24
S Corporations, 15-24
15.7 Overall Comparison of Forms of Doing Business, 15-25

THE BIG PICTURE Tax Solutions for the Real World

WHAT BUSINESS FORM SHOULD I CHOOSE?

Bill and George are going to start a new business and have come to you for advice on the most appropriate form for the business. They have narrowed the choice to a C corporation, an S corporation, or an LLC but would like you to advise them as to the primary advantages and disadvantages of the different forms. They have an adequate amount in savings to initially finance the business. Limited liability is a significant concern as is limiting the amount of taxes paid. Bill and George anticipate the company will lose money in the first two years of operation. After that, however, they expect to earn $200,000 in before-tax profit and distribute any after-tax profit to the owners. Bill and George are both single and face a marginal tax rate of 28 percent. **Read the chapter and formulate your response.**

A variety of factors, both tax and nontax, can affect the choice of the form of business entity. The form that is appropriate at one point in the life of an entity and its owners may not be appropriate at a different time.

EXAMPLE 1

Eva is a tax practitioner in Kentwood, the Dairy Center of the South. Many of her clients are dairy farmers. She recently had tax planning discussions with two of her clients, Jesse, a Line Creek dairy farmer, and Larry, a Spring Creek dairy farmer.

Jesse recently purchased his dairy farm. He is 52 years old and just retired after 30 years of service as a chemical engineer at an oil refinery in Baton Rouge. Eva recommended that he incorporate his dairy farm and elect S corporation status for Federal income tax purposes.

Larry has owned his dairy farm since 2004. He inherited it from his father. At that time, Larry retired after 20 years of service in the U.S. Air Force. He has a master's degree in Agricultural Economics from LSU. His farm is incorporated, and shortly after the date of incorporation, Eva had advised him to elect S corporation status. She now advises him to revoke the S election. ■

Example 1 raises a number of interesting questions. Does Eva advise all of her dairy farmer clients to elect S corporation status initially? Why has she advised Larry

TAX in the NEWS

Should You Check That Box?

The check-the-box rules have been evolving since their introduction into the Regulations in late 1996. They are designed to remove tax considerations from the owners' choice of the legal form in which to conduct business. These provisions act to reduce the owners' exposure to the double taxation of taxable business profits. But taxpayers considering the use of these rules have run into several complications.

- Changing tax entity classifications from year to year comes at a cost. Changing the business form from a corporation to a partnership might trigger taxes for both the entity and its owners, defeating the purpose of the entity change.
- State income tax laws do not always match those of the Code. Several states have been slow to adopt the check-the-box rules, and others have modified the rules in some way. For instance, in several states a one-member limited liability company does not receive the expected tax treatment as a partnership, but is reclassified as a corporation or sole proprietorship. Uncertainty as to the state income tax treatment of a check-the-box selection alone may keep the owners from exercising their supposed freedom of choice of tax entity.

to revoke his S election? Will she advise Jesse to revoke his S election at some time in the future? Will she advise Larry to make another S election at some time in the future? Why did she not advise Larry to dissolve his corporation outright? Could Larry and Jesse have achieved the same tax consequences for their dairy farms if they had operated the farms as limited liability entities or partnerships instead of incorporating? Does the way the farm is acquired (e.g., purchase versus inheritance) affect the choice of business entity for tax purposes?

This chapter provides the basis for comparing and analyzing the tax consequences of business decisions for various types of tax entities (sole proprietorship, partnership, corporation, limited liability entity, and S corporation). Understanding the comparative tax consequences for the different types of entities and being able to apply them effectively to specific fact patterns will result in effective tax planning, which is exactly what Eva was doing with her two clients. As the following discussion illustrates, a variety of potential answers may exist for each of the questions raised by Eva's advice.

15.1 Forms of Doing Business

LO.1

Identify the principal legal and tax forms for conducting a business.

PRINCIPAL FORMS

The principal *legal* forms for conducting a business entity are the sole proprietorship, partnership, limited liability entity, and corporation.[1] From a *Federal income tax* perspective, these same forms are available, but the corporate form can be taxed in either of two ways (S corporation and C or regular corporation). In most instances, the legal form and the tax form are the same.

The taxpayer generally is bound for tax purposes by the legal form that is selected. A major statutory exception to this is the ability of an S corporation to receive tax treatment similar to that of a partnership.[2] In addition, taxpayers sometimes can control which set of tax rules will apply to their business operations. The "check-the-box" Regulations provide an elective procedure that enables certain entities to be classified as partnerships for Federal income tax purposes even though they have corporate characteristics.[3] These Regulations have greatly simplified the determination of entity classification. See Chapter 9 for a more detailed discussion of the check-the-box provisions.

An individual conducting a sole proprietorship files Schedule C of Form 1040. If more than one trade or business is conducted, a separate Schedule C is filed for each

[1] A business entity can also be conducted in the form of a trust or estate.

[2] §§ 1361 and 1362. See Chapter 12.

[3] Reg. §§ 301.7701–1 through –4, and –6. Note that if the business has only one owner, the elective procedure enables the entity to be classified as a sole proprietorship.

TAX in the NEWS

Professional Service Firms and Organizational Form

Many professional service firms (e.g., accountants, architects, lawyers) have chosen to become limited liability partnerships. In the accounting profession, this includes all of the Big 4 (i.e., Deloitte, Ernst & Young, KPMG, and PricewaterhouseCoopers) and most regional and local accounting firms.

An LLP helps to provide protection for the purely personal assets of the partners. Under the LLP organizational structure, the only partners whose personal assets are at risk to pay a judgment are those actually involved in the negligence or wrongdoing at issue. Note, however, that the entity is still responsible for the full judgment. Thus, the capital of the entity is still at risk.

trade or business. A partnership files Form 1065. A corporation files Form 1120, and an S corporation files Form 1120S. An LLC that has elected to be taxed as a partnership files Form 1065.

About 6 million corporations file U.S. income tax returns every year, and about 3.5 million of these use S corporation status. About 2.5 million partnership returns are filed every year, and more than 21 million individual returns report sole proprietorship activities on Schedule C in a typical tax year. The business entity forms that are growing in number the fastest are the sole proprietorship (twice as many as 15 years ago) and the partnership (perhaps due to the popularity of limited liability entities).

LIMITED LIABILITY COMPANIES

A **limited liability company (LLC)** is a hybrid business form that combines the corporate characteristic of limited liability for the owners with the tax characteristics of a partnership.[4] All of the states now permit this legal form for conducting a business.

The most frequently cited nontax benefit of an LLC is the limited liability of the owners. Compared to the other forms of ownership, LLCs offer additional benefits over other forms of business, including the following.

Advantages over S corporations

- Greater flexibility in terms of the number of owners, types of owners, special allocation opportunities, and capital structure.
- Inclusion of entity debt in the owner's basis for an ownership interest.
- More liberal deferral of gain recognition on contributions of appreciated property by an owner (determined under § 721 rather than § 351).
- For securities law purposes, an ownership interest in an LLC is not necessarily a security.

Advantages over C corporations

- Ability to pass tax attributes through to the owners.
- Absence of double taxation.

Advantages over limited partnerships

- Right of all owners to participate in the management of the business.
- Ability of all owners to have limited liability (no need for a general partner).
- For securities law purposes, an ownership interest in an LLC is not necessarily a security (the interest of a limited partner normally is classified as a security).

[4]Depending on state law, an LLC may be organized as a limited liability corporation or a limited liability partnership.

TAX

Revenue Relevance of Corporate versus Individual Taxpayers

Federal income taxes (FIT) provide over half of the Federal budget receipts. As indicated in the table, the portion provided by individual taxpayers (which includes the effect of flow-through entities) far exceeds that provided by corporate taxpayers.

	2008	2009	2010
% of budget receipts from FIT	59%	58%	56%
% of FIT from individual taxpayers	80%	79%	80%
% of FIT from corporate taxpayers	20%	21%	20%

Source: Federal Budget of the United States.

Advantages over general partnerships

- Limited liability for owners.
- Greater continuity of life.
- Limitation on an owner's ability to withdraw from the business.

Among the disadvantages associated with LLCs are the following.

- Requirement in most states that there be at least two owners.
- Inability to qualify for § 1244 ordinary loss treatment.
- Absence of a developed body of case law on LLCs.

15.2 Nontax Factors

LO.2
Include nontax factors in business decisions.

Taxes are only one of many factors to consider when making a business decision. Above all, any business decision should make economic sense.

EXAMPLE 2

Walter is considering investing $10,000 in a limited partnership. He projects that he will be able to deduct the $10,000 capital contribution within the next two years (as his share of partnership losses). Since Walter's marginal tax rate is 35%, the deductions will produce a positive cash-flow effect of $3,500 ($10,000 × 35%). However, there is a substantial risk that he will not recover any of his original investment. If this occurs, his negative cash flow from the investment in the limited partnership is $6,500 ($10,000 − $3,500). Walter must decide if the investment makes economic sense. ■

CAPITAL FORMATION

The ability of an entity to raise capital is a factor that must be considered. A sole proprietorship has the narrowest capital base. Compared to the sole proprietorship, the partnership has a greater opportunity to raise funds through the pooling of owner resources.

EXAMPLE 3

Adam and Beth decide to form a partnership, AB. Adam contributes cash of $200,000, and Beth contributes land with an adjusted basis of $60,000 and a fair market value of $200,000. The partnership is going to construct an apartment building at a cost of $800,000. AB pledges the land and the building to secure a loan of $700,000. ■

The limited partnership offers even greater potential than the general partnership form because a limited partnership can secure funds from investors (i.e., future limited partners).

EXAMPLE 4

Carol and Dave form a limited partnership, CD. Carol contributes cash of $200,000, and Dave contributes land with an adjusted basis of $60,000 and a fair market value of $200,000. The partnership is going to construct a shopping center at a cost of $5 million. Included in this cost is the purchase price of $800,000 for land adjacent to that contributed by Dave. Thirty limited partnership interests are sold for $100,000 each to raise $3 million. CD then pledges the shopping center (including the land) and obtains nonrecourse creditor financing of another $2 million. ■

Both the at-risk limitations and the passive activity loss provisions reduce the tax attractiveness of investments in real estate, particularly in the limited partnership form. In effect, the tax rules themselves place a severe curb on the economic consequences. Chapter 6 presents these loss rules and their critical interaction.

Of the different business entities, the corporate form offers the greatest ease and potential for obtaining owner financing because it can issue additional shares of stock. The ultimate examples of this form are the large public companies that are listed on the stock exchanges.

LIMITED LIABILITY

A corporation offers its owners limited liability under state law. This absence of personal liability on the part of the owners is the most frequently cited advantage of the corporate form.

EXAMPLE 5

Ed, Fran, and Gabriella each invest $25,000 for all the shares of stock of Brown Corporation. Brown obtains creditor financing of $100,000. Brown is the defendant in a personal injury suit resulting from an accident involving one of its delivery trucks. The court awards a judgment of $2.5 million to the plaintiff. The award exceeds Brown's insurance coverage by $1.5 million. Even though the judgment probably will result in Brown's bankruptcy, the shareholders will have no personal liability for the unpaid corporate debts. ■

Limited liability is not available to all corporations. For many years, state laws did not permit professional individuals (e.g., accountants, attorneys, architects, and physicians) to incorporate. Even though professionals now are allowed to incorporate, the statutes do not provide limited liability for the performance of professional services.

Even if state law provides for limited liability, the shareholders of small corporations may forgo this benefit. Quite often, a corporation may be unable to obtain external financing (e.g., a bank loan) at reasonable interest rates unless the shareholders guarantee the loan.

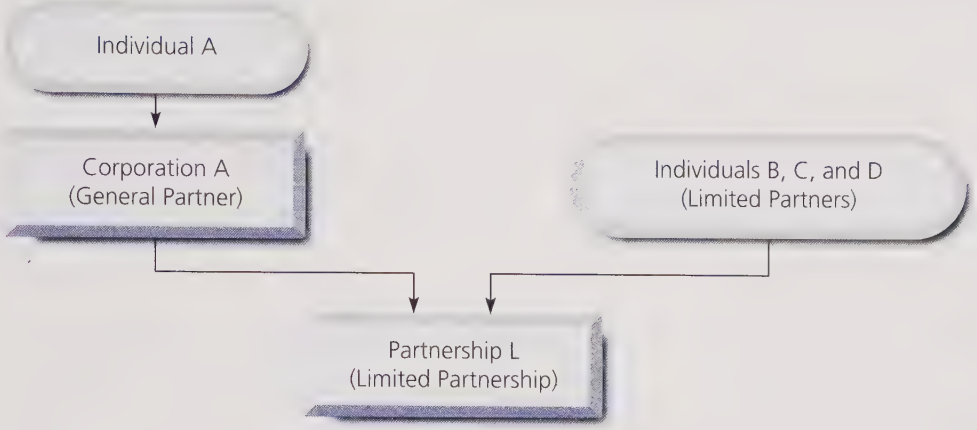
The limited partnership form provides limited liability to the limited partners. Their liability is limited to the amount invested. In contrast, a general partner has unlimited liability.

EXAMPLE 6

Hazel, the general partner, invests $250,000 in HIJ, a limited partnership. Iris and Jane, the limited partners, each invest $50,000. While the potential loss for Iris and Jane is limited to $50,000 each, Hazel's liability is unlimited. ■

Indirectly, it may be possible to provide the general partner with limited liability by establishing a corporation as the general partner (see Figure 15.1). When a venture is structured this way, the general partner (the corporation) has limited its liability under the corporate statutes. In the figure, individual A is protected from personal liability by being merely the shareholder of Corporation A.

FIGURE 15.1 Limited Partnership with a Corporate General Partner



OTHER FACTORS

Other nontax factors may be significant in selecting an organization form, such as:

- Estimated life of the business.
- Number of owners and their roles in the management of the business.
- Freedom of choice in transferring ownership interests.
- Organizational formality, including the related cost and extent of government regulation.

15.3 Single versus Double Taxation

LO.3

Distinguish between the forms for conducting a business according to whether they are subject to single taxation or double taxation.

OVERALL IMPACT ON ENTITY AND OWNERS

The sole proprietorship, limited liability entity, and partnership are subject to a *single* level of Federal income taxation. This result occurs because the owner(s) and the business generally are not considered separate entities for tax purposes. The tax liability is levied at the owner level rather than at the entity level.

In contrast, a corporation and its owners can be subject to *double* taxation. This is frequently cited as the major tax disadvantage of the corporate form. The entity is taxed on the earnings of the corporation, and the owners are taxed on distributions to the extent they are made from corporate earnings.[5]

The S corporation provides a way to avoid double taxation and possibly subject corporate earnings to a lower tax rate (the individual tax rate may be lower than the corporate tax rate). However, the ownership structure of an S corporation is restricted in both the number and type of shareholders. In addition, statutory exceptions subject the entity to taxation in certain circumstances.[6] To the extent these corporate-level taxes apply, double taxation results. Finally, the distribution policy of the S corporation may create difficulties under the *wherewithal to pay* concept.

EXAMPLE 7

Hawk Corporation has been operating as an S corporation since it began its business two years ago. For both of the prior years, Hawk incurred a tax loss. Hawk has taxable income of $75,000 this year and expects that its earnings will increase each year in the foreseeable future. Part of this earnings increase results from Hawk's expansion into other communities in the state. Since most of this expansion will be financed internally, no dividend distributions will be made to Hawk's shareholders.

[5]If the corporation is a personal service corporation (see Chapter 9), the corporation is subject to a flat tax rate of 35%.

[6]Recall the Chapter 12 discussions of the taxes on an S corporation's built-in gains, LIFO recapture, and investment income.



Bridge to Business Law and Financial Accounting

When a business entity is created and assets are transferred to the business entity by the owners, the tax balance sheet and the financial accounting balance sheet generally will contain different amounts for the assets. The balance sheet amounts are a function of whether conduit theory or entity theory is applied.

Conduit theory, also referred to as aggregate theory or proprietary theory, assumes that the business entity is merely an extension of the owners. Therefore, the transfer of the assets by the owners to the entity is not a taxable event. The owners' basis for their ownership interests is a carryover basis. The business entity's basis for its assets is a carryover basis.

Entity theory assumes that the business entity is separate and apart from the owners. Therefore, the transfer of assets by the owners to the entity is a taxable event. The owners' basis for their ownership interests is a new basis (i.e., fair market value). The business entity's basis for its assets is a new basis (i.e., fair market value).

Financial accounting uses entity theory. Thus, the critical value is the fair market value of each asset contributed by an owner to the business entity. Tax generally uses conduit theory. Thus, the critical value is the owner's adjusted basis for the contributed assets.

Assuming all of Hawk's shareholders are in the 33% tax bracket, their tax liability on corporate earnings will be $24,750 ($75,000 × 33%). Even though Hawk will not distribute any cash to the shareholders, they still will be required to pay the tax liability. This creates a wherewithal to pay problem. In addition, the corporate tax liability would have been less if Hawk had not been an S corporation [(15% × $50,000) + (25% × $25,000) = $13,750].

The shareholders' wherewithal to pay problem could be resolved by terminating the S corporation election. The tax liability would then be imposed at the corporate level. Since Hawk does not intend to make any dividend distributions, double taxation at the present time would be avoided. Terminating the election also reduces the overall tax liability by $11,000 ($24,750 − $13,750).[7]

In making the decision about the form of business entity, Hawk's shareholders should consider more than the current taxable year. If the S election is terminated, another election might not be available for five years. Thus, the decision to revoke the election should be made using at least a five-year planning horizon. Perhaps a better solution would be to retain the election and distribute enough dividends to the S corporation shareholders to enable them to pay the shareholder tax liability. ■

Two other variables that relate to the adverse effect of double taxation are the timing and form of corporate distributions. If no distributions are made, then only single taxation occurs in the short run.[8] To the extent that double taxation does occur in the future, the cash-flow effect should be discounted to its present value. Second, when the distribution is made, is it in the form of a dividend or a return of capital?[9] The owners likely would prefer to receive long-term capital gain (subject to lower tax rates) instead of ordinary income. Proper structuring of the distribution can accomplish this result. Note that for distributions made in 2003 and thereafter the availability of the beneficial rate (15%/0% in 2008–2010 and 15%/5% before 2008) for qualified dividends reduces the potential negative impact of double taxation (see Chapter 4).

[7]The absence of distributions to shareholders could create an accumulated earnings tax (AET) problem under § 531. However, as long as earnings are used to finance expansion, the "reasonable needs" provision will be satisfied, and the corporation will avoid any AET. Refer to the discussion of the AET in Chapter 10.

[8]This assumes there is no accumulated earnings tax problem. See especially Example 10 in the subsequent discussion of distributions in Minimizing Double Taxation.

[9]Redemptions of stock and corporate liquidations may be taxed as a sale of stock to shareholders (i.e., as capital gain or loss). See § 302 and Chapter 10.

Tax Planning Strategies SELLING STOCK VERSUS SELLING CORPORATE ASSETS

FRAMEWORK FOCUS: TAX RATE

Strategy: Avoid Double Taxation.

Molly owns all of the stock of Peach, Inc., a C corporation that she wants to sell. Since she started the business, the fair market value of the corporate assets and the value of her stock investment have appreciated by about $7 million. The C corporation's marginal tax rate is 34 percent. Unfortunately, the buyer of the corporation is interested only in purchasing its assets and does not want to buy the stock.

Molly's objective is to avoid double taxation, and she is considering the following alternatives.

- Sell the C corporation stock for its fair market value to her wholly owned S corporation. The S corporation then will liquidate the C corporation. As the value of the assets received will equal the purchase price of the stock, no gain will result, and only the C corporation is subject to tax.
- Have the C corporation elect S corporation status and then liquidate.
- Liquidate the C corporation (i.e., sell off all of the assets). Because the sale of the assets produces the same results as a sale of the stock, she accounts for the liquidation as a stock sale.
- Offer the buyer a $500,000 reduction in the purchase price if he will agree to purchase the stock rather than the corporate assets.

Evaluate these four alternatives in terms of achieving Molly's objective.

ALTERNATIVE MINIMUM TAX

All of the forms of business are directly or indirectly subject to the alternative minimum tax (AMT).[10] For the sole proprietorship and the C corporation, the effect is direct (the AMT liability calculation is attached to the tax form that reports the entity's taxable income—Form 1040 or Form 1120). For the partnership, limited liability entity, and S corporation, the effect is indirect; the tax preferences and adjustments pass through from the entity to the owners, and the AMT liability calculation is *not* assessed on the tax form that reports the entity's taxable income—Form 1065 or Form 1120S.

When compared to other entities, the C corporation appears to have a slight advantage. The corporate AMT rate of 20 percent is less than the individual AMT rates of 26 and 28 percent. An even better perspective is provided by comparing the maximum AMT rate with the maximum regular rate for both the individual and the

TAX in the NEWS DO CORPORATIONS PAY TAXES?

A disadvantage of being a C corporation is the potential for double taxation. This potential disappears, however, if the taxable income of the corporation is zero or negative.

A Government Accountability Office (GAO) study indicates that for the period 1996–2000, more than 60 percent of U.S. corporations did not owe or pay any Federal income taxes. Neither did 70 percent of foreign-owned corporations doing business in the United States. By 2003, corporate tax receipts had fallen to 7.4 percent of overall Federal receipts, the lowest percentage since 1983.

Another GAO study released in early 2009 found that 83 of the largest publicly traded corporations maintain subsidiaries in 50 tax havens. Senator Carl Levin (who requested the GAO study) along with Senator Byron Dorgan, both Democrats, concluded that "too many corporations are finagling ways to dodge paying Uncle Sam, despite the benefits they receive from doing business in this country."

[10] § 55.

corporation. For the individual, the AMT rate is 80 percent (28%/35%) of the maximum regular rate. The AMT rate for the corporation is 57 percent (20%/35%) of the maximum regular rate. Therefore, on the basis of comparative rates, the C corporation appears to offer lower AMT tax burdens. In addition, as presented below, under certain circumstances, a C corporation is exempt from the AMT.

The apparent corporate AMT rate advantage may be more than offset by the ACE adjustment, which applies only to C corporations.[11] If the ACE adjustment continually causes the C corporation to be subject to the AMT, the owners should consider electing S corporation status (if eligibility requirements can be satisfied). Since the S corporation does not compute an ACE adjustment, it may be possible to reduce the tax liability.

The AMT does not apply to modest-sized C corporations. To be exempt from the tax, the corporation must meet both of the following tests.

- Average annual gross receipts of not more than $5 million for the three tax years after 1993.
- Average annual gross receipts of not more than $7.5 million for every subsequent three-tax-year period.

A corporation automatically is classified as a small corporation in the first year of existence. About 95 percent of all C corporations are likely to meet these tests and be exempt from the AMT in the future.

Tax Planning Strategies **PLANNING FOR THE AMT**

FRAMEWORK FOCUS: TAX RATE

Strategy: Shift Net Income from High-Bracket Years to Low-Bracket Years.

If the AMT will apply in the current year, the entity should consider accelerating income and delaying deductions, so that current-year taxable income is taxed at the lower AMT rate. For a C corporation, the potential rate differential is 15 percentage points (20 percent AMT rate versus 35 percent regular tax rate). For an individual (i.e., as a sole proprietor, as a partner, or as an S corporation shareholder), the potential tax rate differential is 7 percentage points (28 percent highest AMT rate versus 35 percent regular tax rate). A present value analysis should be used to assure that the income acceleration and deduction deferral do not increase actual tax liabilities.

STATE TAXATION

In selecting a form for doing business, the determination of the tax consequences should not be limited to Federal income taxes. Consideration also should be given to state income taxes and, if applicable, local income taxes.

The S corporation provides a good illustration of this point. Suppose that the forms of business being considered are a limited partnership or a corporation. An operating loss is projected for the next several years. The owners decide to operate the business in the corporate form. The principal nontax criterion for the decision is the limited liability attribute of the corporation. The owners consent to an S corporation election, so the corporate losses can be passed through to the shareholders to deduct on their individual tax returns. However, assume that state law does not permit the S corporation election. Thus, the owners will not receive the tax benefits of the loss deductions that would have been available on their state income tax returns if they had chosen the limited partnership form. As a result of providing limited liability to the owner who would have been the general partner for the limited partnership, the loss deduction at the state level is forgone.

[11] §§ 56(c)(1) and (f). Refer to the discussion of the corporate AMT in Chapter 14.

TAX in the NEWS

WHO PAYS CORPORATE AMT?

One of the issues often raised in debates over tax legislation is whether the corporate AMT should be repealed. Among the topics discussed are the revenue generated, the related compliance costs, and the number of corporations subject to the AMT.

According to the IRS, nearly 6 million corporate tax returns were filed in 2003. Of these returns, under 15,000 included any AMT.

Proponents of the corporate AMT argue that these statistics show that the AMT is being paid by corporations targeted by the law (i.e., large corporations). Opponents argue that the same statistics show that the compliance costs borne by the mass of corporations do not justify the continuation of this tax system.

The exemption from the AMT for small corporations may be providing the needed solution. Large corporations must make minimal Federal income tax payments when the AMT applies. Most C corporations no longer need to compute the tax.

Source: IRS Tax Stats.

15.4 MINIMIZING DOUBLE TAXATION

LO.4
Identify techniques for avoiding double taxation.

Only the corporate form is potentially subject to double taxation. Several techniques are available for eliminating or at least reducing the second layer of taxation.

- Making distributions to the shareholders that are deductible to the corporation.
- Not making distributions to the shareholders.
- Making distributions that qualify for return of capital treatment at the shareholder level.
- Making the S corporation election.

MAKING DEDUCTIBLE DISTRIBUTIONS

The following are typical distribution forms that will result in a deduction to the corporation.

- Salary payments to shareholder-employees.
- Lease or rental payments to shareholder-lessors.
- Interest payments to shareholder-creditors.

Recognizing the potential for abuse, the IRS scrutinizes these types of distributions carefully. All three forms are evaluated in terms of *reasonableness.*[12] In addition, interest payments to shareholders may lead to reclassification of some or all of the debt as equity.[13] IRS success with either approach raises the specter of double taxation.

EXAMPLE 8

Donna owns all the stock of Green Corporation and is also the chief executive officer. Green's taxable income before salary payments to Donna is as follows.

2008	2009	2010
$80,000	$50,000	$250,000

[12] § 162(a)(1). *Mayson Manufacturing Co. v. Comm.*, 49–2 USTC ¶9467, 38 AFTR 1028, 178 F.2d 115 (CA–6, 1949); *Harolds Club v. Comm.*, 65–1 USTC ¶9198, 15 AFTR 2d 241, 340 F.2d 861 (CA–9, 1965).

[13] § 385; Rev.Rul. 83–98, 1983–2 C.B. 40; *Bauer v. Comm.*, 84–2 USTC ¶9996, 55 AFTR 2d 85–433, 748 F.2d 1365 (CA–9, 1984).

TAX in the NEWS

Who Pays the Corporate Federal Income Tax and Why It Is Decreasing

C corporations and their shareholders potentially are subject to double taxation. Tax legislation enacted in 2003 substantially reduced the combined burden by making qualified dividends eligible for beneficial tax rates (i.e., 15%/5%/0%). Another option considered at that time, but rejected by the administration and Congress, was to eliminate taxation at the C corporation level and have corporate profits taxed at the shareholder level.

A question that frequently arises in this continuing debate is just how heavy the corporate Federal income tax burden is. An analysis by the Government Accountability Office shows that larger companies (assets of more than $250 million or gross receipts over $50 million) are more likely to pay income taxes than smaller ones. In 2000, 55 percent of larger companies paid Federal income taxes whereas fewer than 50 percent did so in 2002. The authors of the report believe that many larger companies could bring their tax burden down to $0 if they chose to do so. To do so, however, would create "unwanted attention."

One of the reasons for the falling corporate tax burden is that larger portions of corporate earnings are being generated in countries that impose lower tax rates. General Electric is an example of this trend. GE paid income tax on earnings at a rate of 21.7 percent in 2003 compared with 28.3 percent in 2001. GE's annual report for 2003 attributed this decline in its tax burden to "the increasing share of earnings from lower taxed international operations."

During the year, Donna receives a monthly salary of $3,000. In December of each year, Donna reviews the operations for the year and determines the year-end bonus she is to receive. Donna's yearly bonuses are as follows.

2008	2009	2010
$44,000	$14,000	$214,000

The apparent purpose of Green's bonus program is to reduce the corporate taxable income to zero and thereby avoid double taxation. An examination of Green's tax return by the IRS would likely result in a deduction disallowance for **unreasonable compensation**. ■

EXAMPLE 9

Tom and Vicki each contribute $20,000 to TV Corporation for all of its stock. In addition, they each lend $80,000 to TV. The loan is documented by formal notes, the interest rate is 8%, and the maturity date is 10 years from the date of the loan.

The notes provide the opportunity for the corporation to make payments of $6,400 each year to both Tom and Vicki and for the payments not to be subject to double taxation. This happens because the interest payments are includible in the gross income of Tom and Vicki, but are deductible by TV in calculating its taxable income. At the time of repayment in 10 years, neither Tom nor Vicki recognizes gross income from the repayment; the $80,000 amount realized is equal to the basis for the note of $80,000.

If the IRS succeeded in reclassifying the notes as equity, Tom and Vicki still would have gross income of $6,400, but the interest would be reclassified as dividend income (which may be taxed at the 15% rate). Because dividend payments are not deductible by TV, the corporation's taxable income would increase by $12,800 ($6,400 × 2). To make matters worse, the repayment of the notes in 10 years would not qualify as a recovery of capital, resulting in additional dividend income for Tom and Vicki. ■

NOT MAKING DISTRIBUTIONS

Double taxation will not occur unless the corporation makes (actual or deemed) distributions to the shareholders. A closely held corporation that does not make

distributions may eventually encounter an accumulated earnings tax problem unless the reasonable needs requirement is satisfied. When making distribution decisions each year, the board of directors should be apprised of any potential accumulated earnings tax problem and take the appropriate steps to eliminate it. The accumulated earnings tax rate of 15 percent in 2010 is the same as the 15 percent rate for qualified dividends for individual taxpayers.[14]

EXAMPLE 10

According to an internal calculation made by Dolphin Corporation, its accumulated taxable income is $400,000. The board of directors would prefer not to declare any dividends, but is considering a dividend declaration of $400,000 to avoid the accumulated earnings tax. All of the shareholders are in the 35% bracket.

If a dividend of $400,000 is declared, the tax cost to the shareholders is $60,000 ($400,000 × 15%, assuming the dividends are qualified dividends). If a dividend is not declared and the IRS assesses the accumulated earnings tax, the tax cost to the corporation for the accumulated earnings tax also would be $60,000 ($400,000 × 15%).

To make matters worse, Dolphin will have incurred the accumulated earnings tax cost without getting any funds out of the corporation to the shareholders. If the unwise decision were now made to distribute the remaining $340,000 ($400,000 − $60,000) to the shareholders, the additional tax cost at the shareholder level would be $51,000 ($340,000 × 15%). Therefore, the combined shareholder-corporation tax cost would be $111,000 ($60,000 + $51,000). This is 185% ($111,000/$60,000) of the tax cost that would have resulted from an initial dividend distribution of $400,000. ■

The legislation that created the special tax rate of 15 percent for qualified dividends also lowered the accumulated earnings tax rate from 35 percent to 15 percent. This tax rate reduction has substantially lowered the impact of the accumulated earnings tax. In Example 10, the penalty tax at the corporate level prior to the legislative change would have been $140,000 ($400,000 × 35%). Assuming the remaining $260,000 was distributed to the shareholders, the additional tax cost at the shareholder level would have been $91,000 ($260,000 × 35%). Therefore, the combined shareholder-corporation tax cost would have been $231,000 ($140,000 + $91,000) rather than the current $111,000. Thus, by reducing both the tax rate for the accumulated earnings tax and the tax rate on qualified dividends, this legislative change thereby reduced the taxpayer's net tax cost of the accumulated earnings tax.

Assuming that the accumulated earnings tax can be avoided (e.g., a growth company whose reasonable needs justify its failure to pay dividends), a policy of no distributions to shareholders can avoid the second layer of taxation on corporate earnings. The retained earnings will drive the value of the shares upward, equal to the accumulated after-tax cash. As a result of the step-up in basis rules for inherited property, the basis of the stock for the beneficiaries will be the fair market value at the date of the decedent's death rather than the decedent's basis.

RETURN OF CAPITAL DISTRIBUTIONS

The exposure to double taxation can be reduced if the corporate distributions to the shareholders can qualify for return of capital rather than dividend treatment. This can occur when the corporation's earnings and profits (E & P) are low or negative in amount. Review Example 1 in Chapter 10. In some cases, the stock redemption provisions offer an opportunity to avoid dividend treatment altogether. Under these rules, the distribution may be treated as a sale of the shareholder's stock, resulting in a tax-free recovery of basis and then recognition of low-tax long-term capital gain.

[14] § 531. Refer to the discussion of the accumulated earnings tax in Chapter 10.

Bridge DISCIPLINE

Bridge to Economics

Corporations such as Coca Cola, IBM, Microsoft, Wal-Mart, and ExxonMobil are major players not only in their industries, but also in the world economy. However, people are also attracted to "mom and pop type stores," which cumulatively play a major role in the economy.

In recognition of the important role of small businesses and their size competitive disadvantage at times, Congress has provided small businesses with beneficial tax treatment that is not available to major business entities. Included among such beneficial treatments are the following.

- § 11 beneficial tax rates.
- § 44 disabled access credit.
- § 55(e) exemption from the AMT for small corporations.
- § 179 limited expensing for tangible personal property.
- § 1045 deferral of gain for qualified small business stock.
- § 1202 for partial exclusion of gain for certain small business stock.
- § 1244 ordinary loss treatment.

Each of these provisions defines "small" in a different way. Sometimes, however, when beneficial tax treatment is provided for a business entity, the term "small" may be used inappropriately. The classic example is the small business corporation of Subchapter S. Some S corporations hold billions of dollars of assets. They are "small" only in the sense that the number of shareholders cannot exceed 100 unrelated shareholders.

ELECTING S CORPORATION STATUS

Electing S corporation status generally eliminates double taxation. Several factors, listed below, should be considered when making this election.

- Are all the shareholders willing to consent to the election?
- Can the qualification requirements under § 1361 be satisfied at the time of the election?
- Can the S corporation requirements continue to be satisfied?
- For what period will the conditions that make the election beneficial continue to prevail?
- Will the corporate distribution policy create wherewithal to pay problems at the shareholder level?

EXAMPLE 11

Emerald Corporation commenced business in January 2010. The two shareholders, Diego and Jaime, are both in the 28% tax bracket. The following operating results are projected for the first five years of operations.

2010	2011	2012	2013	2014
($50,000)	$400,000	$600,000	$800,000	$1,000,000

The corporation plans to expand rapidly. Therefore, no distributions will be made to shareholders. In addition, beginning in 2011, preferred stock will be offered to a substantial number of investors to help finance the expansion.

If the S corporation election is made for 2010, the $50,000 loss can be passed through to Diego and Jaime. The loss will generate a positive cash-flow effect of $14,000 ($50,000 × 28%). Assume that the election is either revoked or is involuntarily terminated at the beginning of 2011 as a result of the issuance of the preferred stock. The corporate tax liability for 2011 is $136,000 ($400,000 × 34%).

If the S corporation election is not made for 2010, the $50,000 loss is a net operating loss. The amount can be carried forward to reduce the 2011 corporate taxable income to $350,000 ($400,000 − $50,000). The resultant tax liability is $119,000 ($350,000 × 34%).

Should the S corporation election be made for just the one-year period? The answer is unclear. With an assumed after-tax rate of return to Diego and Jaime of



Number of Income Tax Returns Filed by Different Types of Taxpayers (in Millions)

Type of Taxpayer	1980	1985	1990	1995	2000	2008
Individual	93.1	99.5	112.3	116.1	126.9	153.5
Partnership	1.4	1.8	1.8	1.6	2.1	3.4
C corporation	2.1	2.4	2.3	2.2	2.2	2.5
S corporation	.5	.7	1.5	2.2	2.8	4.4

The number of S corporation returns has increased dramatically since 1980. LLCs usually file as partnerships, and the popularity of this entity form has led to a notable increase in the number of partnership returns filed.

Source: IRS Tax Stats.

10%, the value of the $14,000 one year hence is $15,400 ($14,000 × 110%). Even considering the time value of money, the combined corporation-shareholder negative cash-flow effect of $120,600 ($136,000 − $15,400) in the case of an S election is not significantly different from the $119,000 corporate tax liability that would result for a C corporation. ■

Another benefit of electing S corporation status is that the corporation is not subject to the accumulated earnings or personal holding company taxes.

15.5 Conduit versus Entity Treatment

LO.5

Understand and apply the conduit and entity concepts as they affect operations, capital changes, and distributions.

Under the **conduit concept**, the entity is viewed as merely an extension of the owners. Under the **entity concept**, the entity is regarded as being separate and distinct from its owners. The effects of the conduit and entity concepts extend to a variety of tax rules, including the following.

- Recognition at time of contribution to the entity.
- Basis of ownership interest.
- Results of operations.
- Recognition at time of distribution.
- Passive activity losses.
- At-risk rules.
- Special allocations.

The sole proprietorship is not analyzed separately because the owner and the business are the same tax entity. In one circumstance, however, a tax difference can result. Income recognition does not occur when an owner contributes an asset to a sole proprietorship. Thus, the business generally takes a carryover basis. However, if the asset is a personal-use asset, the sole proprietorship's basis is the *lower of* the adjusted basis or the fair market value at the date of contribution. If a personal-use asset is contributed to a partnership or corporation, this same *lower-of* rule applies.

EFFECT ON RECOGNITION AT TIME OF CONTRIBUTION TO THE ENTITY

Since the conduit approach applies to partnerships, § 721 provides for no recognition on the contribution of property to a partnership in exchange for a partnership

interest. Section 721 protects both a contribution associated with the formation of the partnership and later contributions. The partnership takes a carryover basis in the contributed property, and the partners have a carryover basis in their partnership interests.[15]

Since the entity approach applies to corporations, the transfer of property to a corporation in exchange for its stock is a taxable event. However, if the § 351 control requirement (80 percent) is satisfied, no gain or loss is recognized. In this case, both the corporate property and the shareholders' stock have a carryover basis.[16] This control requirement makes it possible for shareholders who contribute appreciated property to the corporation *after* its formation to recognize gain.

To the extent that the fair market value of property contributed to the entity at the time of formation is not equal to the property's adjusted basis, the entity might want to make a special allocation associated with the subsequent sale of the contributed property. With a special allocation, the owner contributing the property receives the tax benefit or detriment for any recognized gain or loss that subsequently results because of the initial difference between the adjusted basis and the fair market value. For the partnership, this special allocation treatment is mandatory. No such allocation is available for a C corporation because the gain or loss is recognized at the corporation level rather than at the shareholder level. As with a C corporation, no such allocation is available for an S corporation. The recognized gain or loss is reported on the shareholders' tax returns according to their stock ownership.

EXAMPLE 12

Khalid contributes land with an adjusted basis of $10,000 and a fair market value of $50,000 for a 50% ownership interest. At the same time, Tracy contributes cash of $50,000 for the remaining 50% ownership interest. Because the entity is unable to obtain the desired zoning, it subsequently sells the land for $50,000.

If the entity is a C corporation, Khalid has a realized gain of $40,000 ($50,000 − $10,000) and a recognized gain of $0 resulting from the contribution. His basis in the stock is $10,000, and the corporation has a basis in the land of $10,000. The corporation realizes and recognizes a gain of $40,000 ($50,000 − $10,000) when it sells the land. Thus, what should have been Khalid's recognized gain is now the corporation's taxable gain. There is no way that the corporation can allocate the recognized gain directly to Khalid. The corporation could distribute the land to Khalid and let him sell it, but such a distribution is likely to be taxable to Khalid as a dividend, and gain on the distribution is also recognized at the corporate level.

If the entity is a partnership or limited liability entity, the tax consequences are the same as for the C corporation, except for the $40,000 recognized gain on the sale of the land. The partnership realizes and recognizes a gain of $40,000 ($50,000 − $10,000). However, even though Khalid's share of profits and losses is only 50%, all of the $40,000 recognized gain is allocated to him. If the entity is an S corporation, the tax consequences are the same as for the C corporation, except that Khalid reports $20,000 of the recognized gain on his tax return and Tracy also reports $20,000. ■

Not all contributions of assets to corporations are made by shareholders. States and local governments continue to lure businesses to locate in a particular state or locality with promises of tax breaks and grants. See the additional discussion of this topic in the "Tax in the News" feature on the next page.

EFFECT ON BASIS OF OWNERSHIP INTEREST

In the case of a partnership or an LLC, the contribution of property to the entity in exchange for an ownership interest is not a taxable event under § 721. Therefore, the owner's basis for the ownership interest is a carryover basis. For C and S corporations, the nontaxable and the related carryover basis results are appropriate only if the 80 percent control requirement of § 351 is satisfied. If the control requirement is

[15]Refer to the pertinent discussion in Chapter 11.

[16]Refer to the pertinent discussion in Chapter 9.

TAX in the NEWS

A Tax Reversal: State Governments Pay for Jobs

State governments continue to offer direct and indirect subsidies (i.e., cash payments, infrastructure development, and tax holidays) in an effort to woo companies that will generate jobs for the area. Jon Corzine, then governor of New Jersey, promised to send a $3,000 check to every small business that hired a new employee. Minnesota Governor Tim Pawlenty called for an expansive package of tax cuts that would include tax-free zones for companies that create "green jobs."

Providing such incentives, particularly in a recession, makes economic sense. For example, Texas put up $10 million to persuade Caterpillar to locate a new assembly plant, projected to employ 1,400 workers, in the small town of Seguin. Days after breaking ground, Caterpillar announced 20,000 job cuts worldwide, but stated that it remains committed to the new plant as a long-term growth strategy.

But what happens if companies do not keep their promises and the new jobs do not materialize? More and more states, including Texas, are inserting "clawback" provisions in their agreements. Clawback provisions require companies to return some or all of the funds provided by the state government if the promised jobs are not created.

Source: Adapted from Stephanie Simon, "More States Considering Tax Breaks to Woo Jobs," *Wall Street Journal*, February 2, 2009, p. A1.

not satisfied, any realized gain or loss on the transaction is recognized, and the stock basis is equal to the fair market value of the contributed property.

In a partnership or a limited liability entity, since the owner is the taxpayer, profits and losses of the partnership affect the owner's basis in the entity interest. Likewise, the owner's basis is increased by the share of entity liability increases and is decreased by the share of liability decreases. Accordingly, ownership basis changes frequently.[17]

Because a C corporation is a taxpaying entity, the shareholder's basis for the stock is not affected by corporate profits and losses or corporate liability changes.

The treatment of an S corporation shareholder falls between that of the partner and the C corporation shareholder. The S corporation shareholder's stock basis is increased by the share of profits and decreased by the share of losses, but it usually is not affected by corporate liability increases or decreases.[18]

EXAMPLE 33

Peggy contributes cash of $100,000 to an entity for a 30% ownership interest. The entity borrows $50,000 and repays $20,000 of this amount by the end of the taxable year. The profits for the year are $90,000.

If the entity is a partnership or limited liability entity, Peggy's basis at the end of the period is $136,000 ($100,000 investment + $9,000 share of net liability increase + $27,000 share of profits). If Peggy is a C corporation shareholder instead, her stock basis is $100,000 ($100,000 original investment). If the corporation is an S corporation, Peggy's stock basis is $127,000 ($100,000 + $27,000). ■

EFFECT ON RESULTS OF OPERATIONS

The entity concept is responsible for producing potential double taxation for the C corporation if the corporation is taxed on its earnings, and the shareholders are taxed on the distribution of earnings. Thus, from the perspective of taxing the results of operations, the entity concept appears to provide a disadvantage to corporations. However, whether the entity concept actually produces disadvantageous results depends on the following.

- Whether the corporation generates positive taxable income.
- The tax rates that apply to the corporation and to the shareholders.
- The distribution policy of the corporation.

[17] §§ 705 and 752.

[18] Recall from Chapter 12 that pass-through S corporation losses can reduce a *shareholder's* basis in loans to the entity.

As discussed previously, techniques exist for getting cash out of the corporation to the shareholders without incurring double taxation (e.g., compensation payments to shareholder-employees, lease payments to shareholder-lessors, and interest payments to shareholder-creditors). Since these payments are deductible to the corporation, they reduce corporate taxable income. If the payments can be used to reduce corporate taxable income to zero, the corporation will have no tax liability.

The maximum individual tax rate currently is the same as the maximum corporate tax rate (35 percent). However, in a specific situation, the corporate tax rates that apply may be greater than or less than the applicable individual tax rates.

Double taxation occurs only if distributions (actual or constructive) are made to the shareholders. Thus, if no distributions (actual or constructive) are made and if the entity can avoid the accumulated earnings tax (e.g., based on the statutory credit or the reasonable needs adjustment) and the personal holding company tax (e.g., the corporation primarily generates active income), only one current level of taxation will occur. If the distribution can qualify for return of capital rather than dividend treatment, the shareholder tax liability is decreased. Finally, taxation of the earnings at the shareholder level can be avoided permanently if the stock passes through the decedent shareholder's estate.[19]

Application of the entity concept causes income and deductions to lose any unique tax characteristics when they are passed through to shareholders in the form of dividends. This may produce a negative result for capital gains. Since capital gains lose their identity when passed through in the form of dividends, they cannot be used to offset capital losses at the shareholder level. An even more negative result is produced when dividends are paid out of tax-exempt income. Tax-exempt income is excludible in calculating corporate taxable income, but is included in calculating current earnings and profits. Thus, exclusions from income may be taxed because of the entity concept.

Partnerships, limited liability entities, and S corporations use the conduit concept in reporting the results of operations. Any item that is subject to special treatment on the taxpayer-owner's tax return is reported separately to the owner. Other items are aggregated and reported as taxable income. Thus, taxable income merely represents the sum of income and deductions that are not subject to special treatment.[20]

Many of the problems that the entity concept may produce for the C corporation form are not present in pass-through entities. In particular, pass-through entities are not subjected to double taxation, problems with the reasonableness requirement, or loss of identity of the income or expense item at the owner level.

Only partnerships and limited liability entities completely apply the conduit concept when reporting the results of operations. In several circumstances, the S corporation is subject to taxation at the corporate level, including the tax on built-in gains. This limited application of the entity concept necessitates additional planning to attempt to avoid taxation at the corporate level.

EFFECT ON RECOGNITION AT TIME OF DISTRIBUTION

The application of the conduit concept results in distributions not being taxed to the owners. The application of the entity concept produces the opposite result. Therefore, tax-free distributions can be made to owners of flow-through entities, whereas distributions to C corporation shareholders may be taxable.

A combination entity/conduit concept applies to property distributions from S corporations. The conduit concept applies with respect to the shareholder. However, if the distributed property has appreciated in value, any realized gain is recognized at the corporate level.[21] This is the same treatment received by C corporations. Thus, corporate-level gain recognition is an application of the entity concept, whereas the pass-through of the gain to shareholders is an application of the conduit concept.

[19]Recall Chapter 7's analysis of the basis step-up rules for property acquired from a decedent.

[20]§§ 701, 702, 1363, and 1366.

[21]§ 311(b).

TAX in the NEWS

CERTAIN PARTNERSHIP DISTRIBUTIONS OF APPRECIATED PROPERTY

Section 311(b) of the Internal Revenue Code, which is applicable to C corporations and S corporations, provides that realized gain on the distribution of appreciated property to a shareholder results in recognized gain to the corporation. There is no similar statutory provision for the distribution of appreciated property made by a partnership to a partner.

However, the IRS has held that in one limited circumstance a distribution of appreciated property made by a partnership to a partner results in recognized gain to the partnership. If the appreciated property is distributed to the partner in satisfaction of a guaranteed payment under § 707(c), the distribution in treated as a sale or exchange under § 1001 rather than a distribution under § 731.

EXAMPLE 31

Tan, an S corporation, is equally owned by Leif and Matt. Tan distributes two parcels of land to Leif and Matt. Tan has a basis of $10,000 for each parcel. Each parcel has a fair market value of $15,000. The distribution results in a $10,000 ($30,000 − $20,000) recognized gain for Tan. Leif and Matt each report $5,000 of the gain on their individual income tax returns. ■

Stock redemptions and complete liquidations receive identical treatment whether a C or an S corporation is involved.[22]

EFFECT ON PASSIVE ACTIVITY LOSSES

The passive activity loss rules apply to flow-through entities, personal service corporations, and closely held C corporations. A *closely held C corporation* exists when more than 50 percent of the value of the outstanding stock at any time during the last half of the taxable year is owned by or for not more than five individuals. A corporation is classified as a *personal service corporation* if the following requirements are satisfied.[23]

- The principal activity of the corporation is the performance of personal services.
- The services are substantially performed by owner-employees.
- Owner-employees own more than 10 percent in value of the stock of the corporation.

The general passive loss rules apply to personal service corporations. Therefore, passive activity losses can be offset only against passive activity income. For closely held corporations, the application of the passive activity rules is less harsh. Passive activity losses can be offset against both active and passive income.

Since the conduit concept applies to partnerships, S corporations, and limited liability entities, the passive activity results are separately stated at the entity level and are passed through to the owners with their passive character maintained.

EFFECT OF AT-RISK RULES

The at-risk rules apply to all flow-through entities and to closely held C corporations. The rules produce a harsher result for partnerships and limited liability entities than for S corporations. This occurs because of the way liabilities affect partners' basis.

[22] §§ 302, 331, and 336.

[23] § 469, derived from the definition in § 269A.

TAX in the NEWS

When Rent Is Active Rather Than Passive

A major shareholder of a closely held S corporation leased an airplane to the corporation at a fair rental. As part of the lease agreement, the owner provided a pilot and crew. The lease also required that a replacement airplane be made available when repairs were needed for the leased aircraft. If the deductions associated with the airplane exceed the rent income, is any such loss active or passive? According to a recent Revenue Ruling, significant services are being provided. Thus, the lease activity is classified as active rather than passive, and the loss is not subject to the § 469 passive activity limits.

EXAMPLE 15

Walt is the general partner, and Ira and Vera are the limited partners in the WIV limited partnership. Walt contributes land with an adjusted basis of $40,000 and a fair market value of $50,000 for his partnership interest, and Ira and Vera each contribute cash of $100,000 for their partnership interests. They agree to share profits and losses equally. To finance construction of an apartment building, the partnership obtains $600,000 of nonrecourse financing [not qualified nonrecourse financing under § 465(b)(6)] using the land and the building as the pledged assets. Each partner's basis for the partnership interest is as follows.

	Walt	Ira	Vera
Contribution	$ 40,000	$100,000	$100,000
Share of nonrecourse debt	200,000	200,000	200,000
Basis	$240,000	$300,000	$300,000

Without the at-risk rules, Ira and Vera could pass through losses up to $300,000 each even though they invested only $100,000 and have no personal liability for the nonrecourse debt. However, the at-risk rules limit the loss pass-through to the at-risk basis, which is $100,000 for Ira and $100,000 for Vera.

The at-risk rules also affect the general partner. Since Walt is not at risk for the nonrecourse debt, his at-risk basis is $40,000. If the mortgage were recourse debt, his at-risk basis would be $640,000 ($40,000 + $600,000).

If, instead, the entity were an S corporation and Walt received 20% of the stock and Ira and Vera each received 40%, the basis for their stock would be as follows.

Walt	Ira	Vera
$40,000	$100,000	$100,000

In S corporations, nonrecourse debt does not affect the calculation of stock basis. The stock basis for each shareholder would remain the same even if the debt were recourse debt. Only direct loans by the shareholders increase the ceiling on loss pass-through. ■

EFFECT OF SPECIAL ALLOCATIONS

An advantage of the conduit concept over the entity concept is the ability to make special allocations. Special allocations are not permitted in C corporations. Indirectly, however, the corporate form may be able to achieve results similar to those produced by special allocations through payments to owners (e.g., salary payments, lease rental payments, and interest payments) and through different classes of stock (e.g., preferred and common). However, even in these cases, the breadth of the treatment and the related flexibility are far less than that achievable under the conduit concept.

Although S corporations generally operate as conduits, they are treated more like C corporations than partnerships with respect to special allocations. This treatment results from the application of the per-share and per-day allocation rule in

Partnership Income Tax Returns: Profits versus Losses

Since 1980, the number of partnership income tax returns has more than doubled (i.e., from 1.4 million returns to 3.4 million returns). The beneficial tax treatment of LLCs is expected to cause this trend to continue. While the partnership provides a tax shelter opportunity by passing losses through to the partner, a majority of partnerships are profitable.

	1980	1985	1990	1995	2000	2007
% of returns with profits	57%	53%	56%	63%	60%	54%
% of returns with losses	43%	47%	44%	37%	40%	46%

Source: IRS Tax Stats.

§ 1377(a). Although S corporations are limited to one class of stock, they still can use salary, interest, and rental payments to owners to shift income to the desired recipient. However, the IRS can reallocate income among members of a family if fair returns are not provided for services rendered or capital invested.[24]

EXAMPLE 23

The stock of an S corporation is owned by Debra (50%), Helen (25%), and Joyce (25%). Helen and Joyce are Debra's adult children. Debra is subject to a 35% marginal tax rate, and Helen and Joyce have a 15% marginal tax rate. Only Debra is an employee of the corporation. She is paid an annual salary of $20,000, whereas employees with similar responsibilities in other corporations earn $100,000. The corporation generates earnings of approximately $200,000 each year.

It appears that the reason Debra is paid a low salary is to enable more of the earnings of the S corporation to be taxed to Helen and Joyce, who are in lower tax brackets. Thus, the IRS could use its statutory authority to allocate a larger salary to Debra. ■

Partnerships and limited liability entities have many opportunities to use special allocations, including the following (refer to Chapter 11).

- The ability to share profits and losses differently from the share in capital.
- The ability to share profits and losses differently.
- A required special allocation for the difference between the adjusted basis and the fair market value of contributed property.
- The special allocation of some items if a substantial economic effect rule is satisfied.

15.6 Disposition of a Business or an Ownership Interest

LO.6

Analyze the effects of the disposition of a business on the owners and the entity for each of the forms for conducting a business.

A key factor in evaluating the tax consequences of a business disposition is whether the disposition is viewed as the sale of an ownership interest or as a sale of assets. Generally, the tax consequences are more favorable to the seller if the transaction is treated as a sale of the ownership interest.

[24] § 1366(e).

SOLE PROPRIETORSHIPS

Regardless of the form of the transaction, the sale of a sole proprietorship is treated as the sale of individual assets. Thus, gains and losses must be calculated separately for each asset. Classification as capital gain or ordinary income depends on the nature and holding period of the individual assets. Ordinary income property such as inventory will result in ordinary gains and losses. Section 1231 property such as land, buildings, and machinery used in the business will produce § 1231 gains and losses (subject to depreciation recapture under §§ 1245 and 1250). Capital assets such as investment land and stocks qualify for capital gain or loss treatment.

If the amount realized exceeds the fair market value of the identifiable assets, the excess is allocated to goodwill, which produces capital gain for the seller. If instead the excess payment is allocated to a covenant not to compete, the related gain is classified as ordinary income rather than capital gain. Both goodwill and covenants are amortized over a 15-year statutory period.[25]

EXAMPLE 21

Seth, who is in the 35% tax bracket, sells his sole proprietorship to Wilma for $600,000. The identifiable assets are as follows.

	Adjusted Basis	Fair Market Value
Inventory	$ 20,000	$ 25,000
Accounts receivable	40,000	40,000
Machinery and equipment*	125,000	150,000
Buildings**	175,000	250,000
Land	40,000	100,000
	$400,000	$565,000

*Potential § 1245 recapture of $50,000.
**Potential § 1250 recapture of $20,000.

The sale produces the following results for Seth.

	Gain (Loss)	Ordinary Income	§ 1231 Gain	Capital Gain
Inventory	$ 5,000	$ 5,000		
Accounts receivable	–0–			
Machinery and equipment	25,000	25,000		
Buildings	75,000	20,000	$ 55,000	
Land	60,000		60,000	
Goodwill	35,000			$35,000
	$200,000	$50,000	$115,000	$35,000

If the sale is structured this way, Wilma can deduct the $35,000 paid for goodwill over a 15-year period. If instead Wilma paid the $35,000 to Seth for a covenant not to compete for a period of seven years, she still would amortize the $35,000 over a 15-year period. However, Seth's $35,000 capital gain would now be taxed to him as ordinary income. If the covenant has no legal relevance to Wilma, in exchange for treating the payment as a goodwill payment, she should negotiate for a price reduction that reflects Seth's benefit from the lower capital gains tax. ■

[25] § 197.

TAX in the NEWS

A One-Way Street for Partners

Janel paid $800,000 for Waldo's partnership interest in the DWT Partnership. Waldo's outside basis was $600,000, which equaled his share of the partnership's inside basis for the partnership assets. Unless the partnership makes a § 754 election, Janel eventually will pay income taxes on the $200,000 difference between her outside basis of $800,000 and her share of the inside basis of $600,000. A § 754 election will activate § 743 and provide her with a special basis adjustment of $200,000. But does she recognize the need for making the § 754 election, and will the other partners cooperate?

Suppose the amounts are reversed (i.e., Janel paid $600,000 for an inside basis of $800,000). In this situation, Janel would prefer to avoid making the § 754 election. But the tax law limits the partners' ability to make this choice. An automatic downward basis adjustment is required if the partnership has a "substantial built-in loss" at the time of the transfer.

This § 743 treatment applies only to losses. For built-in gains, an affirmative § 754 election is necessary to trigger an upward § 743 basis adjustment.

PARTNERSHIPS AND LIMITED LIABILITY ENTITIES

The sale of a partnership or limited liability entity can be structured as the sale of assets or as the sale of an ownership interest. If the transaction takes the form of an asset sale, it is treated the same as for a sole proprietorship. The sale of an ownership interest is treated as the sale of a capital asset, although ordinary income potential exists for unrealized receivables and substantially appreciated inventory. Thus, if capital gain treatment can produce beneficial results for the taxpayer (e.g., he or she has capital losses to offset or has beneficially treated net capital gain), the sale of an ownership interest is preferable.

From a buyer's perspective, tax consequences are not affected by the form of the transaction. If the transaction is an asset purchase, the basis for the assets equals the amount paid. If a buyer intends to continue to operate as an LLC or a partnership, the assets can be contributed to the entity under § 721. Therefore, the owner's basis in the entity interest is equal to the purchase price for the assets. Likewise, if ownership interests are purchased, the owner's basis is the purchase price paid. The partnership's basis for the assets is the purchase price since the original partnership will have terminated.[26]

When the inside and outside basis of a partner's ownership interest differ (see Chapter 11), an election can be made to step up the partner's share of the entity's asset bases.[27] This tax-free basis step-up applies to all such exchanges by all of the partners as long as the election is in effect. The election allows asset basis to reflect increases in fair market value and the goodwill that a new partner has purchased.

EXAMPLE 28

Roz buys a one-third interest in the RST Partnership for $50,000 (outside basis). All of the entity's assets are depreciable, and their basis to the partnership (inside basis) is $90,000. If a § 754 election is in effect, the partnership can step up the basis of its depreciable assets by $20,000, the difference between Roz's outside and inside basis amounts [$50,000 − (1/3 × $90,000)]. All of the "new" asset basis is allocated to Roz. ■

[26] § 708(b)(1)(B).

[27] §§ 743 and 754.

Tax Planning Strategies SELLING STOCK OR ASSETS

FRAMEWORK FOCUS: TAX RATE

Strategy: Avoid Double Taxation.

Structuring the sale of the business as a stock sale may produce detrimental tax results for the purchaser. As Example 19 illustrates, the basis of the corporation's assets is not affected by the stock sale. If the fair market value of the stock exceeds the corporation's adjusted basis for its assets, the purchaser is denied the opportunity to step up the basis of the assets to reflect the amount in effect paid for them through the stock acquisition—no § 754 election is available to C corporations.

For an asset sale, the seller of the business can be either the corporation or its shareholders. If the seller is the corporation, the corporation sells the business (the assets), pays any debts not transferred, and makes a liquidating distribution to the shareholders. If the sellers are the shareholders, the corporation pays any debts that will not be transferred and makes a liquidating distribution to the shareholders; then the shareholders sell the business.

Regardless of the approach used for an asset sale, double taxation will occur. The corporation is taxed on the actual sale of the assets and is taxed as if it had sold the assets when it makes the liquidating distribution to the shareholders who then sell the distributed assets. The shareholders are taxed when they receive cash or assets distributed in-kind by the corporation.

The asset sale resolves the purchaser's problem of not being able to step up the basis of the assets to their fair market value. The basis for each asset is its purchase price. To operate in corporate form (assuming the purchaser is not a corporation), the purchaser needs to transfer the property to a corporation in a § 351 transaction.

From the perspective of the seller, the ideal form of the transaction is a stock sale. Conversely, from the purchaser's perspective, the ideal form is an asset purchase. Double taxation seldom can be avoided in either case. Therefore, the bargaining ability of the seller and the purchaser to structure the sale as a stock sale or an asset sale, respectively, is critical.

Rather than selling the entire business, an owner may sell only his or her ownership interest. Since the form of the transaction is a stock sale, the results for the selling shareholder will be the same as if all the shareholders had sold their stock (i.e., capital gain or capital loss).

C CORPORATIONS

The sale of a business held by a C corporation can be structured as either an asset sale or a stock sale. The stock sale has the dual advantage to the seller of being less complex both as a legal transaction and as a tax transaction. It also has the advantage of providing a way to avoid double taxation. Finally, any gain or loss on the sale of the stock is treated as a capital gain or loss to the shareholder.

EXAMPLE 19

Jane and Zina each own 50% of the stock of Purple Corporation. They have owned the business for 10 years. Jane's basis in her stock is $40,000, and Zina's basis in her stock is $60,000. They agree to sell the stock to Rex for $300,000. Jane recognizes a long-term capital gain of $110,000 ($150,000 − $40,000), and Zina recognizes a long-term capital gain of $90,000 ($150,000 − $60,000). Rex has a basis in his stock of $300,000. Purple's basis in its assets does not change as a result of the stock sale. ■

S CORPORATIONS

Since the S corporation is a corporation, it is subject to the provisions for a C corporation discussed previously. Either an asset sale at the corporate level or a liquidating distribution of assets produces recognition at the corporate level. However, under the conduit concept applicable to the S corporation, the recognized amount is taxed at the shareholder level. Therefore, double taxation is avoided directly (only the

shareholder is involved) for a stock sale and indirectly (the conduit concept ignores the involvement of the corporation) for an asset sale.

Double taxation might seem to be avoided by making an S corporation election prior to the liquidation of a C corporation, but the built-in gains tax closes this loophole; taxation occurs at the corporate level, and double taxation results.

Concept Summary 15.1 reviews the tax consequences of business dispositions.

15.7 Overall Comparison of Forms of Doing Business

Concept Summary 15.2 provides a detailed comparison of the tax consequences of the various forms of doing business.

LO.7

Compare the tax consequences of the most common legal forms of doing business.



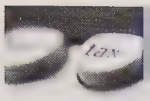
CONCEPT SUMMARY 15.1

Tax Treatment of Disposition of a Business

Form of Entity	Form of Transaction	Tax Consequences	
		Seller	Buyer
Sole proprietorship	Sale of individual assets.	Gain or loss is calculated separately for the individual assets. Classification as capital or ordinary depends on the nature and holding period of the individual assets. If amount realized exceeds the fair market value of the identifiable assets, the excess is allocated to goodwill (except to the extent identified with a covenant not to compete), which is a capital asset.	Basis for individual assets is the allocated cost. Prefers that any excess of purchase price over the fair market value of identifiable assets be identified with a covenant not to compete if the covenant has legal utility. Otherwise, the buyer is neutral since both goodwill and covenants are amortized over a 15-year statutory period.
	Sale of the business.	Treated as a sale of the individual assets (as above).	Treated as a purchase of the individual assets (as above).
Partnership and limited liability entity	Sale of individual assets.	Treatment is the same as for the sole proprietorship.	Treatment is the same as for the sole proprietorship. If the intent is to operate in partnership form, the assets can be contributed to a partnership under § 721.
	Sale of ownership interest.	Entity interest is treated as the sale of a capital asset under § 741 (subject to ordinary income potential under § 751 for unrealized receivables and substantially appreciated inventory).	Basis for new owner's ownership interest is the cost. The new entity's basis for the assets is also the pertinent cost (i.e., contributed to the entity under § 721), since the original entity will have terminated.
C corporation	Sale of corporate assets by corporation (i.e., corporation sells assets, pays debts, and makes liquidating distribution to the shareholders).	Double taxation occurs. Corporation is taxed on the sale of the assets with the gain or loss determination and the classification as capital or ordinary treated the same as for the sole proprietorship. Shareholders calculate gain or loss as the difference between the stock basis and the amount received from the corporation in the liquidating distribution. Capital gain or loss usually results, since stock typically is a capital asset.	Basis for individual assets is the allocated cost. If the intent is to operate in corporate form, the assets can be contributed to a corporation under § 351.

Tax Treatment of Disposition of a Business—Continued

Form of Entity	Form of Transaction	Tax Consequences	
		Seller	Buyer
	Sale of corporate assets by the shareholders (i.e., corporation pays debts and makes liquidating distribution to the shareholders).	Double taxation occurs. At the time of the liquidating distribution to the shareholders, the corporation is taxed as if it had sold the assets. Shareholders calculate gain or loss as the difference between the stock basis and the fair market value of the assets received from the corporation in the liquidating distribution. Capital gain or loss usually results, since stock typically is a capital asset.	Same as corporate asset sale.
	Sale of corporate stock.	Enables double taxation to be avoided. Since the corporation is not a party to the transaction, there are no tax consequences at the corporate level. Shareholders calculate gain or loss as the difference between the stock basis and the amount received for the stock. Capital gain or loss usually results, since stock typically is a capital asset.	Basis for the stock is its cost. The basis for the corporate assets is not affected by the stock purchase.
S corporation	Sale of corporate assets by corporation.	Recognition occurs at the corporate level on the sale of the assets, with the gain or loss determination and the classification as capital or ordinary treated the same as for the sole proprietorship. Conduit concept applicable to the S corporation results in the recognized amount being taxed at the shareholder level. Double taxation associated with the asset sale is avoided, because the shareholder's stock basis is increased by the amount of gain recognition and decreased by the amount of loss recognition. Shareholders calculate gain or loss as the difference between the stock basis and the amount received from the corporation in the liquidating distribution. Capital gain or loss usually results, since stock typically is a capital asset.	Basis for individual assets is the allocated cost. If the intent is to operate in corporate form (i.e., as an S corporation), the assets can be contributed to a corporation under § 351.
	Sale of corporate assets by the shareholders.	At the time of the liquidating distribution to the shareholders, recognition occurs at the corporation level as if the corporation had sold the assets. The resultant tax consequences for the shareholders and the corporation are the same as for the sale of corporate assets by the S corporation.	Same as corporate asset sale by the corporation.
	Sale of corporate stock.	Same as the treatment for the sale of stock of a C corporation.	Same as the treatment for the purchase of stock of a C corporation.



CONCEPT SUMMARY 15.2

Tax Attributes of Different Forms of Business (Assume Partners and Shareholders Are All Individuals)

	Sole Proprietorship	Partnership/Limited Liability Entity	S Corporation	C Corporation
Restrictions on type or number of owners	One owner. The owner must be an individual.	Must have at least 2 owners.	Only individuals, estates, certain trusts, and certain tax-exempt entities can be owners. Maximum number of shareholders limited to 100.*	None, except some states require a minimum of 2 shareholders.
Incidence of tax	Sole proprietorship's income and deductions are reported on Schedule C of the individual's Form 1040. A separate Schedule C is prepared for each business.	Entity not subject to tax. Owners in their separate capacity subject to tax on their distributive share of income. Entity files Form 1065.	Except for certain built-in gains and passive investment income when earnings and profits are present from C corporation tax years, entity not subject to Federal income tax. S corporation files Form 1120S. Shareholders are subject to tax on income attributable to their stock ownership.	Income subject to double taxation. Entity subject to tax, and shareholder subject to tax on any corporate dividends received. Corporation files Form 1120.
Highest tax rate	35% at individual level.	35% at owner level.	35% at shareholder level.	35% at corporate level plus 15%/0% on any corporate dividends at shareholder level (if qualified dividends; otherwise 35%).
Choice of tax year	Same tax year as owner.	Selection generally restricted to coincide with tax year of majority owners or principal owners, or to tax year determined under the least aggregate deferral method.	Restricted to a calendar year unless IRS approves a different year for business purposes or other exceptions apply.	Unrestricted selection allowed at time of filing first tax return.
Timing of taxation	Based on owner's tax year.	Owners report their share of income in their tax year within which the entity's tax year ends. Owners in their separate capacities are subject to payment of estimated taxes.	Shareholders report their shares of income in their tax year within which the corporation's tax year ends. Generally, the corporation uses a calendar year, but see "Choice of tax year." Shareholders may be subject to payment of estimated taxes. Corporation may be subject to payment of estimated taxes for the taxes imposed at the corporate level.	Corporation subject to tax at close of its tax year. May be subject to payment of estimated taxes. Dividends are subject to tax at the shareholder level in the tax year received.

*Spouses and family members can be treated as 1 shareholder.

Tax Attributes of Different Forms of Business—Continued

	Sole Proprietorship	Partnership/Limited Liability Entity	S Corporation	C Corporation
Basis for allocating income to owners	Not applicable (only one owner).	Profit and loss sharing agreement. Cash basis items of cash basis entities are allocated on a daily basis. Other entity items are allocated after considering varying interests of owners.	Pro rata share based on stock ownership. Shareholder's pro rata share is determined on a daily basis, according to the number of shares of stock held on each day of the corporation's tax year.	Not applicable.
Contribution of property to the entity	Not a taxable transaction.	Generally not a taxable transaction.	Is a taxable transaction unless the § 351 requirements are satisfied.	Is a taxable transaction unless the § 351 requirements are satisfied.
Character of income taxed to owners	Retains source characteristics.	Conduit—retains source characteristics.	Conduit—retains source characteristics.	All source characteristics are lost when income is distributed to owners.
Basis for allocating a net operating loss to owners	Not applicable (only one owner).	Profit and loss sharing agreement. Cash basis items of cash basis entities are allocated on a daily basis. Other entity items are allocated after considering varying interests of owners.	Prorated among shareholders on a daily basis.	Not applicable.
Limitation on losses deductible by owners	Investment plus liabilities.	Owner's investment plus share of liabilities.	Shareholder's investment plus loans made by shareholder to corporation.	Not applicable.
Subject to at-risk rules?	Yes, at the owner level. Indefinite carryover of excess loss.	Yes, at the owner level. Indefinite carryover of excess loss.	Yes, at the shareholder level. Indefinite carryover of excess loss.	Yes, for closely held corporations. Indefinite carryover of excess loss.
Subject to passive activity loss rules?	Yes, at the owner level. Indefinite carryover of excess loss.	Yes, at the owner level. Indefinite carryover of excess loss.	Yes, at the shareholder level. Indefinite carryover of excess loss.	Yes, for closely held corporations and personal service corporations. Indefinite carryover of excess loss.
Tax consequences of earnings retained by entity	Taxed to owner when earned and increases his or her investment in the sole proprietorship.	Taxed to owners when earned and increases their respective interest bases in the entity.	Taxed to shareholders when earned and increases their respective interest bases in stock.	Taxed to corporation when earned and may be subject to penalty tax if accumulated unreasonably.
Nonliquidating distributions to owners	Not taxable.	Not taxable unless money received exceeds recipient owner's basis in entity interest. Existence of § 751 assets may cause recognition of ordinary income.	Generally not taxable unless the distribution exceeds the shareholder's AAA or stock basis. Existence of accumulated earnings and profits could cause some distributions to be dividends.	Taxable in year of receipt to extent of earnings and profits or if exceeds basis in stock.

Tax Attributes of Different Forms of Business—Continued

	Sole Proprietorship	Partnership/Limited Liability Entity	S Corporation	C Corporation
Capital gains	Taxed at owner level using maximum rate of 0%, 15%, 25%, or 28%.	Conduit—owners must account for their respective shares. Taxed at owner level.	Conduit, with certain exceptions (a possible penalty tax)—shareholders must account for their respective shares. Tax treatment determined at shareholder level.	Taxed at corporate level with a maximum 35% rate. No other benefits.
Capital losses	Only $3,000 of capital losses can be offset each tax year against ordinary income. Indefinite carryover.	Conduit—owners must account for their respective shares. Tax treatment determined at owner level.	Conduit—shareholders must account for their respective shares. Tax treatment determined at shareholder level.	Carried back three years and carried forward five years. Deductible only to the extent of capital gains.
§ 1231 gains and losses	Taxable or deductible at owner level. Five-year lookback rule for § 1231 losses.	Conduit—owners must account for their respective shares. Tax treatment determined at owner level.	Conduit—shareholders must account for their respective shares. Tax treatment determined at shareholder level.	Taxable or deductible at corporate level only. Five-year lookback rule for § 1231 losses.
Foreign tax credits	Available at owner level.	Conduit—tax payments passed through to owners.	Generally conduit—tax payments passed through to shareholders.	Available at corporate level only.
§ 1244 treatment of loss on sale of interest	Not applicable.	Not applicable.	Available.	Available.
Basis treatment of entity liabilities	Not applicable.	Includible in interest basis.	Not includible in stock basis.	Not includible in stock basis.
Built-in gains	Not applicable.	Not applicable.	Possible corporate tax.	Not applicable.
Special allocations to owners	Not applicable (only one owner).	Available if supported by substantial economic effect.	Not available.	Not applicable.
Availability of fringe benefits to owners	None.	None.	None unless a 2% or less shareholder.	Available within antidiscrimination rules.
Effect of liquidation/redemption/reorganization on basis of entity assets	Not applicable.	Usually carried over from entity to owner.	Taxable step-up to fair market value.	Taxable step-up to fair market value.
Sale of ownership interest	Treated as the sale of individual assets. Classification of recognized gain or loss depends on the nature of the individual assets.	Treated as the sale of an entity interest. Recognized gain or loss is classified as capital, although appreciated inventory and receivables are subject to ordinary income treatment.	Treated as the sale of corporate stock. Recognized gain is classified as capital gain. Recognized loss is classified as capital loss, subject to ordinary loss treatment under § 1244.	Treated as the sale of corporate stock. Recognized gain is classified as capital gain. Recognized loss is classified as capital loss, subject to ordinary loss treatment under § 1244.
Distribution of appreciated property	Not taxable.	No recognition at the entity level.	Recognition at the corporate level to the extent of the appreciation. Conduit—amount of recognized gain is passed through to shareholders.	Taxable at the corporate level to the extent of the appreciation.

Tax Attributes of Different Forms of Business—Continued

	Sole Proprietorship	Partnership/Limited Liability Entity	S Corporation	C Corporation
Splitting of income among family members	Not applicable (only one owner).	Difficult—IRS will not recognize a family member as an owner unless certain requirements are met.	Rather easy—gift of stock will transfer tax on a pro rata share of income to the donee. However, IRS can make adjustments to reflect adequate compensation for services.	Same as an S corporation, except that donees will be subject to tax only on earnings actually or constructively distributed to them. Other than unreasonable compensation, IRS generally cannot make adjustments to reflect adequate compensation for services and capital.
Organizational costs	Startup expenditures are eligible for $5,000 limited expensing (subject to phaseout) and amortizing balance over 180 months.	Organizational costs are eligible for $5,000 limited expensing (subject to phaseout) and amortizing balance over 180 months.	Same as partnership.	Same as partnership.
Charitable contributions	Limitations apply at owner level.	Conduit—owners are subject to deduction limitations in their own capacities.	Conduit—shareholders are subject to deduction limitations in their own capacities.	Limited to 10% of taxable income before certain deductions.
Alternative minimum tax	Applies at owner level. AMT rates are 26% and 28%.	Applies at the owner level rather than at the entity level. AMT preferences and adjustments are passed through from the entity to the owners.	Applies at the shareholder level rather than at the corporate level. AMT preferences and adjustments are passed through from the S corporation to the shareholders.	Applies at the corporate level. AMT rate is 20%. Modest-sized C corporations are exempt.
ACE adjustment	Does not apply.	Does not apply.	Does not apply.	The adjustment is made in calculating AMTI. The adjustment is 75% of the excess of adjusted current earnings over unadjusted AMTI. If the unadjusted AMTI exceeds adjusted current earnings, the adjustment may be negative.

Tax Planning Strategies CHOOSING A BUSINESS FORM: CASE STUDY

FRAMEWORK FOCUS: TAX RATE

Strategy: Avoid Double Taxation.
Shift Net Income from High-Bracket Taxpayers to Low-Bracket Taxpayers.

The chapter began with an example that illustrated the relationship between tax planning and the choice of business form; it also raised a variety of questions about the advice given by the tax practitioner. By this time, one should be able to develop various scenarios supporting the tax advice given. The actual fact situations that produced the tax adviser's recommendations were as follows.

- Jesse's experience in the dairy industry consists of raising a few heifers during the final five years of his employment. Eva anticipates that Jesse will generate tax losses for the indeterminate future. In addition, Jesse indicated that he and his wife must have limited liability associated with the dairy farm.
- Larry was born and raised on his father's dairy farm. Both his education and his Air Force managerial experience provide him with useful tools for managing his business. However, Larry inherited his farm when milk prices were at a low for the modern era. Since none of her dairy farm clients were profitable, Eva anticipated Larry would operate his dairy farm at a loss. Larry, like Jesse, felt that limited liability was imperative. Thus, he incorporated the dairy farm and made the S election.
- For the first two years, Larry's dairy farm produced tax losses. Since then, the dairy farm has produced tax profits large enough to absorb the losses. Larry anticipates that his profits will remain relatively stable in the $50,000 to $75,000 range in the future. Since he is subject to a 28 percent marginal tax rate and anticipates that no dividend distributions will be made, his tax liability associated with the dairy farm will be reduced if he terminates the S corporation election.

As Jesse and Larry's example illustrates, selection of the proper business form can result in both nontax and tax advantages. Both of these factors should be considered in making the selection decision. Furthermore, this choice should be reviewed periodically, since a proper business form at one point in time may not be the proper form at a different time. Note that another business form Eva could have considered for Jesse is the limited liability entity.

In looking at the tax attributes, consideration should be given to the tax consequences of the following.

- Contribution of assets to the entity by the owners at the time the entity is created and at later dates.
- Taxation of the results of operations.
- Distributions to owners.
- Disposition of an ownership interest.
- Termination of the entity.

REFOCUS ON THE BIG PICTURE

WHAT BUSINESS FORM SHOULD I CHOOSE?

Conducting their business as a C corporation, an S corporation, or an LLC would meet Bill and George's objectives of having limited liability. From a tax perspective, both the S corporation and the LLC would allow the losses in the early years to be passed through to the owners. This cannot be achieved with a C corporation, which would be required to carry over the losses to future years in which the company is profitable. Once the entity starts earning money, the tax consequences are as follows.

- As a C corporation, the entity would pay income tax of $61,250 on taxable earnings of $200,000. If the remaining after-tax earnings of $138,750 are distributed equally to Bill and George (each owner would receive a taxable dividend of $69,375), each shareholder pays an additional income tax of $10,406 ($69,375 × 15%). The combined entity/owner tax liability is $82,062, resulting in after-tax cash flows of $117,938.

CONTINUED

If the entity is operated as an S corporation or an LLC, no tax is paid at the entity level. However, the entire $200,000 is taxed as ordinary income at the owner level, resulting in each owner paying $28,000 ($100,000 × 28%) income tax. The combined entity/owner tax liability is $56,000, resulting in after-tax cash flows of $144,000.

It appears that either the S corporation or the LLC meets Bill and George's objectives of having limited liability and minimizing tax liability. The LLC form offers an additional advantage in that an LLC need not satisfy the numerous statutory qualification requirements to elect and maintain S corporation status. However, based on the facts in this situation, it is unlikely that satisfying the requirements would create any difficulty for Bill and George.

What If?

What if Bill and George decide to expand the business and reinvest the annual $200,000 before-tax earnings instead of paying out dividends to the owners? If the business is organized as a C corporation, it can accumulate the earnings—as long as the company has reasonable business needs—and avoid the additional tax that is paid by Bill and George when the company makes taxable dividend distributions. Although the entity-level tax of $61,250 must still be paid, after-tax cash flows increase to $138,750. While the S corporation or LLC with after-tax cash flows of $144,000 still would be preferred in this situation, the double tax problem of the C corporation can be minimized with effective planning.

SUGGESTED READINGS

Michael Allen, "Gain Tax Benefits by Allocating Price before Closing Sale of a Business," *Practical Tax Strategies*, November 2008.

Sheldon I. Banoff, Paul Carman, and John Maxfield, "Prop. Regs. on Partnership Equity for Services: The Collision of Section 83 and Subchapter K," *Journal of Taxation*, August 2005.

T. J. Estabrook, "Factors to Consider When Making a Choice-of-Entity Decision," *Practical Tax Strategies*, August 2009.

Heather T. Massingill and Michael E. Mares, "Evaluate the Tax Consequences of Changing the Form of an Entity," *Practical Tax Strategies*, July 2007.

Joseph Pozzuolo, Jeffrey H. Smith, and Jeffrey S. Pozzuolo, "Structure a Buy-Sell Agreement for Maximum Utility," *Practical Tax Strategies*, October 2009.

Robert Willins, "When Will a Distribution Be a 'Dividend' and Who Bears the Tax Burden?" *Journal of Taxation*, June 2005.

KEY TERMS

Conduit concept, 15–15

Entity concept, 15–15

Limited liability company (LLC), 15–4

Unreasonable compensation, 15–12

PROBLEMS

1. **LO.2, 3, 4, 5, 6** Using the legend provided, indicate which form of business entity each of the following characteristics describes. Some of the characteristics may apply to more than one form of business entity.

Legend	
SP	= Applies to sole proprietorship
P	= Applies to partnership and LLC
S	= Applies to S corporation
C	= Applies to C corporation
N	= Applies to none

   a. Has limited liability.
   b. Greatest ability to raise capital.
   c. Subject to double taxation.
   d. Subject to accumulated earnings tax.
   e. Limit on types and number of shareholders.
   f. Has unlimited liability.
   g. Sale of the business can be subject to double taxation.
   h. Contribution of property to the entity in exchange for an ownership interest can result in the nonrecognition of realized gain.
   i. Profits and losses affect the basis for an ownership interest.
   j. Entity liabilities affect the basis for an ownership interest.
   k. Distributions of earnings are taxed as dividend income to the owners.
   l. Total invested capital cannot exceed $1 million.
   m. AAA is an account that relates to this entity.

2. **LO.5, 6** Using the legend provided, indicate which form of business entity each of the following characteristics describes. Some of the characteristics may apply to more than one form of business entity.

Legend	
P	= Applies to partnership and LLC
S	= Applies to S corporation
C	= Applies to C corporation

   a. Basis for an ownership interest is increased by an investment by the owner.
   b. Basis for an ownership interest is decreased by a distribution to the owner.
   c. Basis for an ownership interest is increased by entity profits.
   d. Basis for an ownership interest is decreased by entity losses.
   e. Basis for an ownership interest is increased as the entity's liabilities increase.
   f. Basis for an ownership interest is decreased as the entity's liabilities decrease.

3. **LO.2** The Shale Company reports the following assets and liabilities on its balance sheet.

	Net Book Value	Fair Market Value
Assets	$675,000	$975,000
Liabilities	200,000	200,000

Shale has just lost a product liability suit with damages of $5 million being awarded to the plaintiff. Although Shale will appeal the judgment, legal counsel indicates the judgment is highly unlikely to be overturned by the appellate court. The product liability insurance carried by Shale includes a payout ceiling of $3 million. What is the amount of liability of the entity and its owners if Shale is:

a. A sole proprietorship?
b. A partnership or LLC?
c. A C corporation?
d. An S corporation?

ETHICS AND EQUITY

4. **LO.3, 4** Bryan operates his business as a C corporation. He is the only shareholder. The accumulated E & P is $800,000. Starting next year, he plans on distributing $200,000. In future years, he intends to distribute all of the annual earnings. Recognizing that the distribution would be taxed as dividend income, he has developed the following tax strategy.

- Sell the corporate assets to himself for the fair market value.
- Have the corporation invest the sales proceeds in a mutual fund.
- Contribute the assets to an LLC and operate his business in this legal form.

Evaluate Bryan's proposal to avoid double taxation.

5. **LO.3** Red, Green, Blue, and Purple generate taxable income as follows.

Corporation	Taxable Income
Red	$ 98,000
Green	295,000
Blue	800,000
Purple	50,000,000

a. Calculate the marginal and effective tax rates for each of the C corporations.
b. Explain why the marginal tax rate for a C corporation can exceed 35%, but the effective tax rate cannot do so.

DECISION MAKING

COMMUNICATIONS

6. **LO.1, 2, 3** Amy and Jeff Barnes are going to operate their florist shop as a partnership or as an S corporation. Their mailing address is 5700 Richmond Highway, Alexandria, VA 22300. After paying salaries of $100,000 to each of the owners, the shop's earnings are projected to be about $150,000. The earnings are to be invested in the growth of the business. Write a letter to Amy and Jeff advising them of which of the two entity forms they should select.

DECISION MAKING

7. **LO.3** Gerald is an entrepreneur who likes to be actively involved in his business ventures. He is going to invest $500,000 in a business that he projects will produce a tax loss of approximately $125,000 per year in the short run. However, once consumers become aware of the new product being sold by the business and the quality of the service it provides, he is confident the business will generate a profit of at least $200,000 per year. Gerald has substantial other income (from both business ventures and investment activities) each year. Advise Gerald on the business form he should select for the short run. He will be the sole owner.

DECISION MAKING

8. **LO.2, 3** Jack, an unmarried taxpayer, is going to establish a manufacturing business. He anticipates that the business will be profitable immediately due to a patent that he holds. He anticipates that profits for the first year will be about $200,000 and will increase at a rate of about 20% per year for the foreseeable future. He will be the sole owner of the business. Advise Jack on the form of business entity he should select. Jack will be in the 35% tax bracket.

DECISION MAKING

9. **LO.3** Clay Corporation will begin operations on January 1. Earnings for the next five years are projected to be relatively stable at about $90,000 per year. The shareholders of Clay are in the 33% tax bracket.
   a. Clay will reinvest its after-tax earnings in the growth of the company. Should Clay operate as a C corporation or as an S corporation?
   b. Clay will distribute its after-tax earnings each year to its shareholders. Should Clay operate as a C corporation or as an S corporation?

10. **LO.3** Mabel and Alan, who are in the 35% tax bracket, recently acquired a fast-food franchise. Both of them will work in the business and receive a salary of $150,000. They anticipate that the annual profits of the business, after deducting salaries, will be

approximately $400,000. The entity will distribute enough cash each year to Mabel and Alan to cover their Federal income taxes associated with the franchise.

a. What amount will the entity distribute if the franchise operates as a C corporation?
b. What amount will the entity distribute if the franchise operates as an S corporation?
c. What will be the amount of the combined entity/owner tax liability in (a) and (b)?

11. **LO.3** Parrott is a closely held corporation owned by 10 shareholders (each has 10% of the stock). Selected financial information provided by Parrott follows.

Taxable income	$5,250,000
Positive AMT adjustments (excluding ACE adjustment)	425,000
Negative AMT adjustments	(30,000)
Tax preferences	6,000,000
Retained earnings	850,000
Accumulated E & P	775,000
ACE adjustment	720,000

a. Calculate Parrott's tax liability as a C corporation.
b. Calculate Parrott's tax liability as an S corporation.
c. How would your answers in (a) and (b) change if Parrott is not closely held (e.g., 5,000 shareholders with no shareholder owning more than 2% of the stock)?

12. **LO.3** Offshore Fishing Corporation, a calendar year taxpayer, is going to sell real estate that it no longer needs. The real estate is located in Corpus Christi, Texas, and has an adjusted basis of $540,000 ($900,000 – $360,000 MACRS straight-line depreciation) and a fair market value of $840,000. (ADS straight-line depreciation would have been $312,000.) The buyer of the real estate would like to close the transaction prior to the end of the calendar year. Offshore Fishing, however, is uncertain whether the tax consequences would be better if it sold the real estate this year or next year. It is considering the following options.

DECISION MAKING

- $840,000 in cash payable on December 31, 2010.
- The sale will be closed on December 31, 2010, for consideration of an $840,000 note issued by the buyer. The maturity date of the note is January 2, 2011, with the real estate being pledged as security.

Offshore projects its taxable income for 2010 and 2011 to be $900,000 (gross receipts of about $10 million) without the sale of the real estate. Determine the tax consequences to Offshore under each option and recommend the one that should be selected. Consider both the regular income tax and the AMT in making your recommendation.

13. **LO.4** Heron Corporation has been in operation for 10 years. Since Heron's creation, all of the stock has been owned by Andy, who initially invested $200,000 in the corporation. Heron has been successful far beyond Andy's expectations, and the current fair market value of the stock is $10 million. While he has been paid a salary of $200,000 per year by the corporation, all of Heron's earnings have been reinvested in the growth of the corporation.

ETHICS AND EQUITY

Heron is currently being audited by the IRS. One of the issues raised by the IRS agent is the possibility of the assessment of the accumulated earnings tax. Andy is not concerned about this issue because he believes Heron can easily justify the accumulations based on its past rapid expansion by opening new outlets. The expansion program is fully documented in the minutes of Heron's board of directors. Andy has provided this information to the IRS agent.

Two years ago, Andy decided that he would curtail any further expansion into new markets by Heron. In his opinion, further expansion would exceed his ability to manage the corporation effectively. Since the tax year under audit is three years ago, Andy sees no reason to provide the IRS agent with this information.

Heron will continue its policy of no dividend payments into the foreseeable future. Andy believes that if the accumulated earnings issue is satisfactorily resolved on this audit, it probably will not be raised again on any subsequent audits. Thus, double taxation in the form of the tax on dividends at the shareholder level or the accumulated earnings tax at the corporate level can be avoided.

What is Heron's responsibility to disclose to the IRS agent the expected change in its growth strategy? Are Andy's beliefs regarding future accumulated earnings tax issues realistic?

CRITICAL THINKING

14. **LO.4** Three unmarried sisters own and operate a farm. The live on the farm and take their meals on the farm for the "convenience of the employer." The fair market value of their lodging is $40,000, and the fair market value of their meals is $24,000. The meals are prepared for them by the farm cook who prepares their meals along with those of the six other farm employees.
    a. Determine the tax consequences of the meals and lodging to the sisters if the farm is incorporated.
    b. Determine the tax consequences of the meals and lodging to the sisters if the farm is not incorporated.

CRITICAL THINKING

15. **LO.4** A business entity's taxable income before the cost of certain fringe benefits paid to owners and other employees is $400,000. The amounts paid for these fringe benefits are reported as follows.

	Owners	Other Employees
Group term life insurance	$20,000	$40,000
Meals and lodging incurred for the convenience of the employer	50,000	75,000
Pension plan	30,000*	90,000

*H.R. 10 (Keogh) plan for partnership and S corporation.

The business entity is equally owned by four owners.

    a. Calculate the taxable income of the business entity if the entity is a partnership, a C corporation, or an S corporation.
    b. Determine the effect on the owners for each of the three business forms.

16. **LO.4** Turtle, a C corporation, has taxable income of $600,000 before paying salaries to the three equal shareholder-employees, Britney, Shania, and Alan. Turtle follows a policy of distributing all after-tax earnings to the shareholders.
    a. Determine the tax consequences for Turtle, Britney, Shania, and Alan if the corporation pays salaries to Britney, Shania, and Alan as follows.

Option 1		Option 2	
Britney	$270,000	Britney	$135,000
Shania	180,000	Shania	90,000
Alan	150,000	Alan	75,000

    b. Is Turtle likely to encounter any tax problems associated with either option?

17. **LO.4** Swan, Inc., a C corporation, is owned by Abner (70%) and Fran (30%). Abner is the president, and Fran is the vice president for sales. Swan, Abner, and Fran are cash basis taxpayers. Late in 2009, Swan encounters working capital difficulties. Therefore, Abner loans the corporation $560,000 and Fran loans the corporation $240,000. Each loan uses a 5% note that is due in five years with interest payable annually.
    a. Determine the tax consequences to Swan, Abner, and Fran for 2010 if the notes are classified as debt.
    b. Determine the tax consequences to Swan, Abner, and Fran for 2010 if the notes are classified as equity.

DECISION MAKING

COMMUNICATIONS

18. **LO.4** Laurie Gladin owns land and a building that she has been using in her sole proprietorship. She is going to incorporate her sole proprietorship as a C corporation. Laurie must decide whether to contribute the land and building to the corporation or to lease them to the corporation. The net income of the sole proprietorship for the past five years has averaged $250,000. Advise Laurie on the tax consequences. Summarize your analysis in a memo to the tax file.

19. **LO.4** Marci and Jennifer each own 50% of the stock of Lavender, a C corporation. After paying each of them a "reasonable" salary of $150,000, the taxable income of Lavender is normally around $800,000. The corporation is about to purchase a $2 million shopping mall ($1,500,000 allocated to the building and $500,000 allocated to the land). The mall will be rented to tenants at a net rental rate (including rental commissions, depreciation, etc.) of $600,000 annually. Marci and Jennifer will contribute $1 million each to the corporation to provide the cash required for the acquisition. Their CPA has suggested that Marci and Jennifer purchase the shopping mall as individuals and lease it to Lavender for a fair rental of $400,000. Both Marci and Jennifer are in the 35% tax bracket. The acquisition will occur on January 2, 2010. Determine whether the shopping mall should be acquired by Lavender or by Marci and Jennifer in accordance with their CPA's recommendation. Depreciation on the shopping mall in 2010 is $37,000. **DECISION MAKING**

20. **LO.3, 4** Flower, Inc., reports taxable income of $700,000 for 2010. Flower has been in business for many years and long ago used up its accumulated earnings credit. Flower has no additional "reasonable needs of the business" for the current tax year.
    a. Determine Flower's total potential tax liability if it declares no dividends.
    b. Determine Flower's total potential tax liability if it declares and pays dividends equal to the entity's after-tax earnings.
    c. Determine Flower's total potential tax liability in (a) and (b) if it is an S corporation.

21. **LO.4** Since Garnet Corporation was formed six years ago, its stock has been held 750 shares by Frank and 250 shares by Grace. Their basis in the stock is $240,000 for Frank and $160,000 for Grace. As part of a stock redemption, Garnet redeems 100 of Frank's shares for $175,000 and 100 of Grace's shares for $175,000. **DECISION MAKING**
    a. What are the tax consequences of the stock redemption to Frank and Grace?
    b. How would the tax consequences to Frank and Grace be different if, instead of the redemption, they each sell 100 shares to Chuck (an unrelated party)?
    c. What factors should influence their decision on whether to redeem or sell the 200 shares of stock?

22. **LO.4** Oscar created Lavender Corporation four years ago. The C corporation has paid Oscar as president a salary of $200,000 each year. Annual earnings after taxes approximate $700,000 each year. Lavender has not paid any dividends nor does it intend to do so in the future. Instead, Oscar wants his heirs to receive the stock with a step-up in stock basis when he dies. Identify the relevant tax issues. **ISSUE ID**

23. **LO.4** Tammy and Arnold own 40% of the stock of Roadrunner, an S corporation. The other 60% is owned by 99 other shareholders, all of whom are single and unrelated. Tammy and Arnold have agreed to a divorce and are in the process of negotiating a property settlement. Identify the relevant tax issues for Tammy and Arnold. **ISSUE ID**

24. **LO.4** Eagle Corporation has been an electing S corporation since its incorporation 10 years ago. During the first three years of operations, it incurred total losses of $250,000. Since then Eagle has generated earnings of approximately $150,000 each year. None of the earnings have been distributed to the three equal shareholders, Claire, Lynn, and Todd, because the corporation has been in an expansion mode. At the beginning of the year, Claire sells her stock to Nell for $400,000. Nell has reservations about the utility of the S election. Therefore, Lynn, Todd, and Nell are discussing whether the election should be continued. They expect the earnings to remain at approximately $150,000 each year. However, since they perceive that the company's expansion period is over and Eagle has adequate working capital, they may start distributing the earnings to the shareholders. All of the shareholders are in the 33% tax bracket. Advise the three shareholders on whether the S election should be maintained. **DECISION MAKING**

25. **LO.5** Buddy and Bobby form a business entity with each contributing the following property. **DECISION MAKING**

	Buddy	Bobby
Cash	$150,000	
Land		$150,000*

*Fair market value. Bobby's adjusted basis is $90,000.

Four months later, the land is sold for $165,000 because of unexpected zoning problems. The proceeds are to be applied toward the purchase of another parcel of land to be used for real estate development. Determine the tax consequences to the entity and to the owners upon formation and the later sale of the land if the entity is:

a. A partnership.
b. An S corporation.
c. A C corporation.
d. Describe how the parties could structure the transaction so as to defer any recognized tax gain.

26. **LO.5** Agnes, Becky, and Carol form a business entity with each contributing the following.

	Adjusted Basis	Fair Market Value
Agnes: Cash	$100,000	$100,000
Becky: Land	60,000	120,000
Carol: Services		50,000

Their ownership percentages will be as follows.

Agnes	40%
Becky	40%
Carol	20%

Becky's land has a $20,000 mortgage that is assumed by the entity. Carol is an attorney who receives her ownership interest in exchange for legal services. Determine the recognized gain to the owners, the basis for their ownership interests, and the entity's basis for its assets if the entity is organized as:

a. A partnership.
b. A C corporation.
c. An S corporation.

27. **LO.5** Eloise contributes $40,000 to a business entity in exchange for a 30% ownership interest. During the first year of operations, the entity earns a profit of $200,000. At the end of that year, the entity has liabilities of $75,000.
a. Calculate Eloise's basis for her stock if the entity is a C corporation.
b. Calculate Eloise's basis for her stock if the entity is an S corporation.
c. Calculate Eloise's basis for her partnership interest if the entity is a partnership.

28. **LO.5** An entity reports the following income for the current year.

Operations	$92,000
Tax-exempt interest income	19,000
Long-term capital gain	60,000

The entity has earnings and profits (AAA for an S corporation) of $900,000 at the beginning of the year. A distribution of $200,000 is made to the owners.
a. Calculate the taxable income if the entity is (1) a C corporation and (2) an S corporation.
b. Determine the effect of the distribution on the shareholders if the entity is (1) a C corporation and (2) an S corporation.

29. **LO.5** Amber holds a 20% interest in a business to which she contributed $100,000 as part of the initial ownership group. During the life of the business, the following have occurred.

- $200,000 cumulative losses, first three tax years.
- $150,000 operating profit in the fourth tax year.
- $75,000 distribution to owners at the end of the third tax year.
- $60,000 payment to redeem 25% of Amber's ownership interest at the end of the fourth year. No other ownership redemptions have occurred.

Determine the tax consequences to Amber if the entity is organized as:

a. A partnership.
b. An S corporation.
c. A C corporation.

30. **LO.5** The Coffee Company engages in the following transactions during the taxable year.

- Sells stock held for three years as an investment for $30,000 (adjusted basis of $20,000).
- Sells land used in the business for $65,000. The land has been used as a parking lot and originally cost $40,000.
- Receives tax-exempt interest on municipal bonds of $5,000.
- Receives dividends on IBM stock of $80,000.

Describe the effect of these transactions on the entity and its owners if the entity is organized as:

a. A partnership.
b. A C corporation.
c. An S corporation.

31. **LO.5** Swift Corporation distributes land (basis of $12,000 and fair market value of $30,000) to Sam and cash ($45,000) to Allison in exchange for part of their stock. Other shareholders do not redeem any of their stock. Sam surrenders shares of stock that have a basis of $16,000. Prior to the stock redemption, Sam owned 20% of the Swift stock, and after the redemption, he owns 10%.

At the same time, Swift distributes cash to Allison, and she surrenders shares of stock with a basis of $25,000. Prior to the stock redemption, Allison owned 70% of the Swift stock, and after the redemption, she owns 55%.

Determine the tax consequences to Swift, Sam, and Allison if Swift is:

a. A C corporation.
b. An S corporation.

32. **LO.5** Beige, Inc., a personal service corporation, has the following types of income and losses.

Active income	$219,000
Portfolio income	37,000
Passive activity losses	240,000

a. Calculate Beige's taxable income.
b. Assume that instead of being a personal service corporation, Beige is a closely held corporation. Calculate Beige's taxable income.

33. **LO.5** Rosa contributes $50,000 to a business entity in exchange for a 10% ownership interest. Rosa materially participates in the business. The business entity incurs a loss of $900,000 for 2010. The entity liabilities at the end of 2010 are $700,000. Of this amount, $150,000 is for recourse debt, and $550,000 is for nonrecourse debt.

a. Assume the business entity is a partnership. How much of Rosa's share of the loss can be deducted on her 2010 individual tax return? What is Rosa's basis for her partnership interest at the end of 2010?
b. Assume the business entity is a C corporation. How much of Rosa's share of the loss can be deducted on her 2010 individual tax return? What is Rosa's basis for her stock at the end of 2010?

34. **LO.5** Bishop contributes undeveloped land to a business entity in January for a 40% ownership interest. Bishop's basis for the land is $140,000, and the fair market value is $600,000. The business entity was formed three years ago by Petula and Rene, who have equal ownership. The entity is successful in getting the land rezoned from agricultural to residential use, but decides to sell it so that the entity can invest in another project. In August, the land is sold for $650,000. Determine the tax consequences of the sale of the undeveloped land for the business entity and the three owners if the entity is organized as:

a. A C corporation.
b. An S corporation.
c. A partnership.
d. An LLC.

35. **LO.5** Abby and Velma are equal owners of the AV Partnership. Abby invests $75,000 cash in the partnership. Velma contributes land and a building (basis to her of $50,000, fair market value of $75,000). The entity then borrows $200,000 cash using recourse financing and $100,000 using nonrecourse financing.

a. Compute the outside basis in the partnership interest for Abby and Velma.
b. Compute the at-risk amount for Abby and Velma.

36. **LO.5** Megan owns 60% and Vern owns 40% of a business entity. The owners would like to use the entity to share profits (60% for Megan and 40% for Vern) and to share losses (90% for Vern and 10% for Megan). Determine the tax consequences for 2010 if the entity has a tax loss of $100,000 and is organized as:
    a. A partnership.
    b. A C corporation.
    c. An S corporation.

37. **LO.5** Sanjay contributes land to a business entity in January 2010 for a 30% ownership interest. Sanjay's basis for the land is $60,000, and the fair market value is $100,000. The business entity was formed three years ago by Polly and Rita, who have equal ownership. The entity is unsuccessful in getting the land rezoned from agricultural to residential. In October 2010, the land is sold for $110,000.

    Determine the tax consequences of the sale of the land for the entity and its owners if the entity is organized as:
    a. A C corporation.
    b. An S corporation.
    c. A partnership.

38. **LO.6** Emily and Freda are negotiating with George to purchase the business that he operates in corporate form (Pelican, Inc.). The assets of Pelican, Inc., a C corporation, are as follows.

Asset	Basis	FMV
Cash	$ 20,000	$ 20,000
Accounts receivable	50,000	50,000
Inventory	100,000	110,000
Furniture and fixtures	150,000	170,000*
Building	200,000	250,000**
Land	40,000	150,000

*Potential depreciation recapture is $45,000.
**The straight-line method was used to depreciate the building. Accumulated depreciation is $340,000.

George's basis for the stock of Pelican, Inc., is $560,000. George is subject to a 35% marginal tax rate, and Pelican, Inc., faces a 34% marginal tax rate.
    a. Emily and Freda purchase the *stock* of Pelican, Inc., from George for $908,000. Determine the tax consequences to Emily and Freda, Pelican, Inc., and George.
    b. Emily and Freda purchase the *assets* from Pelican, Inc., for $908,000. Determine the tax consequences to Emily and Freda, Pelican, Inc., and George.
    c. The purchase price is $550,000 because the fair market value of the building is $150,000, and the fair market value of the land is $50,000. No amount is assigned to goodwill. Emily and Freda purchase the *stock* of Pelican, Inc., from George. Determine the tax consequences to Emily and Freda, Pelican, Inc., and George.

DECISION MAKING

39. **LO.6** Linda is the owner of a sole proprietorship. The entity has the following assets.

Asset	Basis	FMV
Cash	$10,000	$10,000
Accounts receivable	–0–	25,000
Office furniture and fixtures*	15,000	17,000
Building**	75,000	90,000
Land	60,000	80,000

*Potential depreciation recapture is $5,000.
**The straight-line method has been used to depreciate the building.

Linda sells the business for $260,000 to Juan.

a. Determine the tax consequences to Linda, including the classification of any recognized gain or loss.
b. Determine the tax consequences to Juan.
c. Advise Juan on how the purchase agreement could be modified to produce more beneficial tax consequences for him.

40. **LO.6** Gail and Harry own the GH Partnership. They have conducted the business as a partnership for 10 years. The bases for their partnership interests are as follows. DECISION MAKING

Gail	Harry
$100,000	$150,000

GH Partnership holds the following assets.

Asset	Basis	FMV
Cash	$ 10,000	$ 10,000
Accounts receivable	30,000	28,000
Inventory	25,000	26,000
Building*	100,000	150,000
Land	250,000	400,000

*The straight-line method has been used to depreciate the building. Accumulated depreciation is $70,000.

Gail and Harry sell their partnership interests to Keith and Liz for $307,000 each.

a. Determine the tax consequences of the sale to Gail, Harry, and GH Partnership.
b. From a tax perspective, should it matter to Keith and Liz whether they purchase Gail and Harry's partnership interests or the partnership assets from GH Partnership?

41. **LO.6** Tom and Walt are purchasing the Copper Partnership from Jan and Gail for $425,000; Tom and Walt will be equal partners. During the negotiations, Jan and Gail succeeded in having the transaction structured as the purchase of the partnership rather than as a purchase of the individual assets. The adjusted basis of the individual assets of the Copper Partnership is $360,000. DECISION MAKING

a. What are Tom's and Walt's bases for their partnership interests (i.e., outside bases)?
b. What is Copper's adjusted basis for its assets after the transaction? Would an optional adjustment-to-basis election be helpful?

42. **LO.6** Vladimir owns all the stock of Ruby Corporation. The fair market value of the stock (and Ruby's assets) is about four times his adjusted basis for the stock. Vladimir is negotiating with an investor group for the sale of the corporation. Identify the relevant tax issues for Vladimir. ISSUE ID

43. **LO.6** Swallow, Inc., will purchase either the stock or the assets of Dane Corporation. All of the Dane stock is owned by Chuck. Bill Evans, Swallow's CFO, and Chuck agree that Dane is worth $625,000. The tax basis for Dane's assets is $400,000. Write a letter to Bill advising him on whether he should negotiate for Swallow to purchase the stock or the assets. Bill's address is 100 Village Green, Chattanooga, TN 37403. DECISION MAKING COMMUNICATIONS

Bridge Discipline

1. Parchment, Inc., is created with the following asset and liability contributions. Jake and Fran each receive 100 shares of Parchment common stock.

Shareholder	Assets	Basis	Fair Market Value
Jake	Cash	$100,000	$100,000
Fran	Land	40,000	120,000*

*The land is subject to a mortgage of $20,000 that Parchment assumes.

a. Prepare a financial accounting balance sheet. Discuss the relevance of conduit theory and entity theory.
b. Prepare a tax balance sheet. Discuss the relevance of conduit theory and entity theory.
c. Assume Parchment sells the land four months after the creation of the corporation for $150,000. Discuss the effect on the financial accounting balance sheet and the tax balance sheet.

2. Assume that Parchment in (1) elects S corporation status at the time of its creation. Respond to (a), (b), and (c).

3. Assume that Parchment in (1) is a general partnership rather than a corporation. Respond to (a), (b), and (c). Would your answer change if Parchment were an LLC that "checked the box" to be taxed as a partnership?

4. Teal, Inc., has total assets of $100 million and annual revenues of $700 million. Lavender, Inc., has total assets of $12 million and annual revenues of $900,000. Both have been in existence for three years.
a. Explain why neither Teal nor Lavender need make an AMT calculation for its first tax year.
b. Explain why Teal must make an AMT calculation and why Lavender is not required to do so.
c. Do you think that this different tax treatment for Teal and Lavender is equitable?

RESEARCH PROBLEMS

THOMSON REUTERS
Checkpoint® Student Edition

Note: Solutions to Research Problems can be prepared by using the **Checkpoint® Student Edition** online research product, which is available to accompany this text. It is also possible to prepare solutions to the Research Problems by using tax research materials found in a standard tax library.

Research Problem 1. The stock of Ebony, Inc., is owned as follows.

	Percent Ownership	Basis	FMV
Alma	30%	$2,700	$270,000
Ben	30	2,700	270,000
Debbie	20	1,800	180,000
Clyde	20	1,800	180,000

Alma and Ben are the parents of Debbie and Clyde. Managerial positions in Ebony are as follows: Alma is the chief executive officer (CEO), Ben is the chief operating officer (COO), Debbie is the chief financial officer (CFO), and Clyde is the vice president for human resources. Alma and Ben have owned their stock for 30 years, and Debbie and Clyde have owned their stock for 10 years. Alma and Ben are considering disposing of their stock and would like to use the funds to acquire a more lucrative investment. Their initial plan was to have Ebony redeem their stock. However, their accountant has indicated that since they intend to retain their positions as officers, the redemption will not qualify under § 302(b)(3). The accountant suggests that they sell their stock to several outsiders who wish to acquire an interest in Ebony. As Debbie and Clyde expect to move into the CEO and COO positions in a few years, they oppose a sale to outsiders. They are concerned about the loss of family control that would result.

How can this family dilemma be resolved?

Research Problem 2. Crane is a partner in the Cardinal Partnership. A dispute arose with the partnership regarding Crane's share of current earnings. The partnership contends that the amount is $75,000, while Crane believes his share is $100,000.

Crane ceased being a partner on November 1. As a result of the dispute, the partnership distributed only $75,000 to Crane. It placed the disputed $25,000 in escrow. However, Crane's Schedule K–1 from the partnership included the full $100,000. Crane feels that the K–1 should include only the $75,000 that is not in dispute. Is Crane correct?



Use the tax resources of the Internet to address the following questions. Do not restrict your search to the Web, but include a review of newsgroups and general reference materials, practitioner sites and resources, primary sources of the tax law, chat rooms and discussion groups, and other opportunities.

COMMUNICATIONS

Research Problem 3. Find an article about a state that contributed assets to an auto company as a location inducement and later recovered some or all of the assets under a "clawback" provision. What are the tax consequences to the auto company when it returns these assets to the state? Summarize your findings in no more than three PowerPoint slides, to present to your school's accounting club.

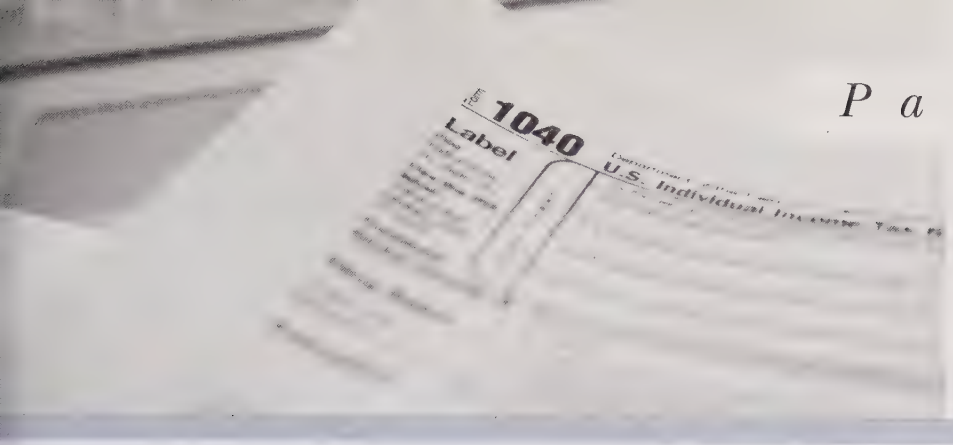
Research Problem 4. When did your state adopt LLC legislation? When did it receive IRS approval to apply partnership tax law to the entities? Provide the pertinent dates and give the citations for the resulting documents.

Research Problem 5. Find an article describing how a specific business put together its employee fringe benefit package in light of the limitations presented by the tax law and its form of operation.

COMMUNICATIONS

Research Problem 6. Find an article that discusses the increasing regulation of "corporate America." Outline the pros and cons of such regulation from your viewpoint and that of the author. In this regard, does it matter whether S or C corporations are involved? Send your list in an e-mail to your instructor.

Research Problem 7. Summarize the marketing campaign used by a company that works with clients to identify investment properties that are producing passive activity income.



Part 6

Taxation of Individuals

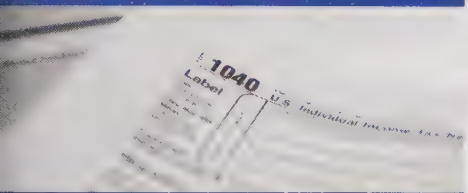
CHAPTER 16 Introduction to the Taxation of Individuals

CHAPTER 17 Individuals as Employees and Proprietors

The primary orientation of this text is toward basic tax concepts as they apply to business entities. Although many of these concepts also apply to the individual taxpayer, numerous tax concepts have been designed to apply specifically to the individual taxpayer. The components of the basic tax model provide the framework for the presentation of these specifically designed tax concepts for the individual taxpayer.

CHAPTER 16

Introduction to the Taxation of Individuals



LEARNING OBJECTIVES

After completing Chapter 16, you should be able to:

LO.1 Recognize and apply the components of the Federal income tax formula for individuals. **(pp. 16-3 to 16-8)**

LO.2 Understand the standard deduction and evaluate its choice in arriving at taxable income. **(pp. 16-8 to 16-10)**

LO.3 Apply the rules for arriving at personal exemptions. **(pp. 16-10 to 16-11)**

LO.4 Apply the rules for determining dependency exemptions. **(pp. 16-12 to 16-18)**

LO.5 Be aware of the filing requirements and choose the proper filing status. **(pp. 16-18 to 16-23)**

LO.6 Use the proper procedures for determining the tax liability. **(pp. 16-23 to 16-26)**

LO.7 Identify and report kiddie tax situations. **(pp. 16-26 to 16-28)**

LO.8 Identify specific inclusions and exclusions applicable to individuals. **(pp. 16-28 to 16-36)**

LO.9 Determine an individual's allowable itemized deductions. **(pp. 16-36 to 16-53)**

LO.10 Understand the adoption expenses credit, child tax credit, education tax credits, credit for child and dependent care expenses, and earned income credit. **(pp. 16-53 to 16-59)**

TAX *Talk*

I'm proud of paying taxes in the United States. The only thing is—I could be just as proud for half the money.

—ARTHUR GODFREY

OUTLINE

16.1 The Individual Tax Formula, 16-3
Components of the Tax Formula, 16-3
16.2 Standard Deduction, 16-8
Basic and Additional Standard Deduction, 16-8
Real Property Taxes and Auto Sales Taxes Standard Deductions, 16-9
Special Limitations on the Standard Deduction for Dependents, 16-10
16.3 Personal Exemptions, 16-10
16.4 Dependency Exemptions, 16-12
Qualifying Child, 16-12
Qualifying Relative, 16-13
Other Rules for Dependency Exemptions, 16-17
Comparison of Categories for Dependency Exemptions, 16-17
Phaseout of Exemptions, 16-18
16.5 Tax Determination—Filing Considerations, 16-18
Filing Requirements, 16-19
Filing Status, 16-21
16.6 Tax Determination—Computation Procedures, 16-23
Tax Table Method, 16-24
Tax Rate Schedule Method, 16-24
Computation of Net Taxes Payable or Refund Due, 16-25
Kiddie Tax—Unearned Income of Children Taxed at Parents' Rate, 16-26
16.7 Overview of Income Provisions Applicable to Individuals, 16-28
16.8 Specific Inclusions Applicable to Individuals, 16-28
Alimony and Separate Maintenance Payments, 16-29
Prizes and Awards, 16-30
Unemployment Compensation, 16-31
Social Security Benefits, 16-31
16.9 Specific Exclusions Applicable to Individuals, 16-31
Gifts and Inheritances, 16-31
Scholarships, 16-32
Damages, 16-33
Workers' Compensation, 16-34
Accident and Health Insurance Benefits, 16-35
Educational Savings Bonds, 16-35
16.10 Itemized Deductions, 16-36
Medical Expenses, 16-37
Taxes, 16-41
Interest, 16-43
Charitable Contributions, 16-47
Miscellaneous Itemized Deductions Subject to Two Percent Floor, 16-52
Other Miscellaneous Deductions, 16-52
Overall Limitation on Certain Itemized Deductions, 16-53
16.11 Individual Tax Credits, 16-53
Adoption Expenses Credit, 16-53
Child Tax Credit, 16-54
Credit for Child and Dependent Care Expenses, 16-54
Education Tax Credits, 16-56
Earned Income Credit, 16-58
Making Work Pay Credit, 16-59

THE BIG PICTURE Tax Solutions for the Real World

THE TAX IMPLICATIONS OF LIFE!

Donna and David Steele recently married and have come to you for tax advice. They have several questions about their tax situation. Both are employed, and they expect to have combined wages of $70,000 during the year. Donna recently graduated from State University and received an academic scholarship in the amount of $5,000 during her last semester of college. Donna paid $8,000 for tuition for the semester and paid $400 of interest on student loans during the year. Donna and David also received a wedding gift of $10,000 from her grandmother, and the couple earned $250 of interest on a savings account they opened with the money. David sold stock for $1,000 that was purchased two years ago for $5,000.

This is David's second marriage, and he pays alimony to his ex-wife. He has custody of his 15-year-old son, Stephen, who lives with Donna and David for nine months each year. The Steeles rent their home, had no unusual medical expenses, paid $3,500 of state income taxes, paid $250 of personal property taxes on their personal cars, and made $2,500 of charitable contributions.

Without calculating Donna and David's tax liability, what are the tax implications of the transactions noted above? Are there other tax deductions or credits for which they may qualify or other tax issues about which they should be made aware? **Read the chapter and formulate your response.**

The individual income tax accounts for approximately 39 percent of Federal budget receipts, compared to approximately 10 percent for the corporate income tax. The tax laws affecting individuals have become increasingly complex in recent years as the government adds new laws to protect or increase this important source of revenue. Taxpayers respond to each new tax act with techniques to exploit loopholes, and the government responds with loophole-closing provisions, making the individual income tax law even more complex.[1]

16.1 The Individual Tax Formula

LO.1

Recognize and apply the components of the Federal income tax formula for individuals.

Individuals are subject to Federal income tax based on taxable income. This chapter explains how taxable income and the income tax of an individual taxpayer are determined. To compute taxable income, it is necessary to understand the tax formula in Figure 16.1.

Although these formula is rather simple, determining an individual's taxable income can be quite complex because of the numerous provisions that govern the determination of gross income and allowable deductions.

After computing taxable income, the appropriate rates must be applied. This requires a determination of the individual's filing status, since different rates apply for single taxpayers, married taxpayers, and heads of household. The individual tax rate structure is progressive, with rates for 2010 ranging from 10 percent to 35 percent.[2] For comparison, the lowest rate structure, which was in effect from 1913 to 1915, ranged from 1 to 7 percent, and the highest, in effect during 1944–1945, ranged from 23 to 94 percent.

Once the individual's tax has been computed, prepayments and credits are subtracted to determine whether the taxpayer owes additional tax or is entitled to a refund.

COMPONENTS OF THE TAX FORMULA

Before illustrating the application of the tax formula, a brief discussion of each of its components is helpful.

Income (Broadly Conceived)

In the tax formula, "income" is broadly conceived and includes all the taxpayer's income, both taxable and nontaxable. Although it is essentially equivalent to gross

FIGURE 16.1 Individual Income Tax Formula

Income (broadly conceived)	$xx,xxx
Less: Exclusions	(x,xxx)
Gross income	$xx,xxx
Less: Deductions *for* adjusted gross income	(x,xxx)
Adjusted gross income (AGI)	$xx,xxx
Less: The greater of—	
Total itemized deductions *or*	
Standard deduction	(x,xxx)
Less: Personal and dependency exemptions	(x,xxx)
Taxable income	$xx,xxx
Tax on taxable income (see Tax Tables or Tax Rate Schedules)	$ x,xxx
Less: Tax credits (including income taxes withheld and prepaid)	(xxx)
Tax due (or refund)	$ xxx

[1]Refer to the discussion of tax complexity in Chapter 1.

[2]The current Tax Rate Schedules that apply to individuals are shown on the inside front cover of the text.

TAX FACT

The Government's Interest in Our Work

How many days does the typical American work just to pay Federal, state, and local taxes? According to the Tax Foundation, the answer is 111 days!. However, the required effort also depends on where the individual lives. In high-tax jurisdictions such as Connecticut and New Jersey, people need to work 130 and 128 days, respectively, while in Louisiana and Alaska, only 94 and 89 days, respectively, are required.

Source: Tax Foundation, 2009.

receipts, it does not include a return of capital or receipt of borrowed funds. Nor does gross income include unrealized appreciation in the value of a taxpayer's assets.

EXAMPLE 1

Dan decides to quit renting and move into a new house. Consequently, the owner of the apartment building returns to Dan the $600 damage deposit he previously made. In order to make a down payment on the house, Dan sells stock for $20,000 (original cost of $8,000) and borrows $50,000 from a bank. Only the $12,000 gain from the sale of the stock is income to Dan. The $600 damage deposit and the $8,000 cost of the stock are a return of capital. The $50,000 bank loan is not income as Dan has an obligation to repay that amount. ■

Exclusions

For various reasons, Congress has chosen to exclude certain types of income from the income tax base. The principal income exclusions are listed in Exhibit 16.1. The exclusions most commonly encountered by individual taxpayers (employee fringe benefits) are discussed in detail in Chapter 17.

Gross Income

The Internal Revenue Code defines gross income broadly as "except as otherwise provided . . . , all income from whatever source derived."[3] The "except as otherwise provided" refers to exclusions. Gross income includes, but is not limited to, the items in Exhibit 16.2.

EXAMPLE 2

Beth received the following amounts during the year:

Salary	$30,000
Interest on savings account	900
Gift from her aunt	10,000
Prize won in state lottery	1,000
Alimony from ex-husband	12,000
Child support from ex-husband	6,000
Damages for injury in auto accident	25,000
Ten $50 bills in an unmarked envelope found in an airport lounge (airport authorities could not locate anyone who claimed ownership)	500
Increase in the value of stock held for investment	5,000

Review Exhibits 16.1 and 16.2 to determine the amount Beth must include in the computation of taxable income and the amount she may exclude. Then check your answer in the footnote.[4] ■

[3] § 61(a).

[4] Beth must include $44,400 in computing taxable income ($30,000 salary + $900 interest + $1,000 lottery prize + $12,000 alimony + $500 found property). She can exclude $41,000 ($10,000 gift from aunt + $6,000 child support + $25,000 damages). The unrealized gain of $5,000 on the stock held for investment is not included in gross income. Such gain will be included in gross income only when it is realized upon disposition of the stock.

EXHIBIT 16.1 Partial List of Exclusions from Gross Income

Accident and health insurance proceeds
Annuity payments (to the extent proceeds represent a recovery of the taxpayer's investment)
Child support payments
Damages for personal injury or sickness
Fringe benefits of employees:

- Educational assistance payments provided by employer
- Employer-provided accident and health insurance
- Group term life insurance (for coverage up to $50,000)
- Meals and lodging (if furnished for convenience of employer)
- Tuition reductions for employees of educational institutions
- Miscellaneous benefits

Gains from sale of principal residence (subject to statutory ceiling)
Gifts and inheritances received
Interest from state and local bonds
Life insurance paid on death of insured
Scholarship grants (to a limited extent)
Social Security benefits (to a limited extent)
Workers' compensation benefits

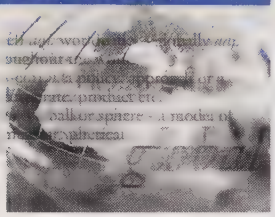
EXHIBIT 16.2 Partial List of Gross Income Items

Alimony
Bargain purchase from employer
Bonuses
Breach of contract damages
Business income
Commissions
Compensation for services
Debts forgiven (with some exceptions)
Dividends
Embezzled funds
Farm income
Fees
Gains from illegal activities
Gains from sale of property
Gambling winnings
Hobby income
Interest
Jury duty fees
Partnership income
Pensions
Prizes (with some exceptions)
Professional fees
Punitive damages
Rents
Rewards
Royalties
Salaries
Severance pay
Strike and lockout benefits
Tips and gratuities
Treasure trove (found property)
Wages

Deductions for Adjusted Gross Income

Individual taxpayers have two categories of deductions: (1) deductions *for* adjusted gross income (deductions to arrive at adjusted gross income) and (2) deductions

GLOBAL *Tax Issues*



Citizenship Is Not Tax-Free

Gross income from "whatever source derived" includes income from both U.S. and foreign sources. This approach to taxation, where the government taxes its citizens and residents on their worldwide income regardless of where earned, is referred to as a *global* system. Income earned by U.S. citizens outside the United States can be subject to additional taxes, however, because all countries maintain the right to tax income earned within their borders. Consequently, the U.S. tax law includes various mechanisms to alleviate the double taxation that arises when income is subject to tax in multiple jurisdictions. These mechanisms include the foreign tax deduction, the foreign tax credit, the foreign earned income exclusion for U.S. citizens and residents working abroad, and various tax treaty provisions.

Most industrialized countries use variants of the global system. An alternative approach is the *territorial* system, where a government taxes only the income earned within its borders. Hong Kong and Guatemala, for example, use a territorial approach.

from adjusted gross income. Deductions *for* adjusted gross income (AGI) include the following:[5]

- Ordinary and necessary expenses incurred in a trade or business.
- One-half of self-employment tax paid.
- Alimony paid.
- Certain payments to traditional Individual Retirement Accounts and Health Savings Accounts.
- Moving expenses.
- The capital loss deduction (limited to $3,000).

Adjusted Gross Income (AGI)

AGI is an important subtotal that serves as the basis for computing percentage limitations on certain itemized deductions, such as medical expenses, charitable contributions, and certain casualty losses. For example, medical expenses are deductible only to the extent they exceed 7.5 percent of AGI, and charitable contribution deductions may not exceed 50 percent of AGI. These limitations might be described as a 7.5 percent *floor* under the medical expense deduction and a 50 percent *ceiling* on the charitable contribution deduction.

EXAMPLE 3

Keith earned a salary of $68,000 in the current year. He contributed $5,000 to his traditional Individual Retirement Account (IRA) and paid alimony of $3,000 to his ex-wife. His AGI is computed as follows:

Gross income		
Salary		$68,000
Less: Deductions *for* AGI		
IRA contribution	$5,000	
Alimony payment	3,000	(8,000)
AGI		$60,000

■

EXAMPLE 4

Assume the same facts as in Example 3, and that Keith also had medical expenses of $5,800. Medical expenses may be included in his itemized deductions to the

[5]See § 62 for a comprehensive list of items that are deductible *for* AGI. Deductions *for* AGI are sometimes known as *above-the-line* deductions because on the tax return they are taken before the "line" designating AGI.

extent they exceed 7.5% of AGI. In computing his itemized deductions, Keith may include medical expenses of $1,300 [$5,800 medical expenses − $4,500 (7.5% × $60,000 AGI)]. ■

Itemized Deductions

As a general rule, personal expenditures are disallowed as deductions in arriving at taxable income. However, Congress allows specific personal expenses as **itemized deductions**. Such expenditures include medical expenses, certain taxes and interest, and charitable contributions. Itemized deductions are discussed in detail later in this chapter.

Leo is the owner and operator of a video game arcade. All allowable expenses he incurs in connection with the arcade business are deductions *for* AGI. In addition, Leo paid medical expenses, mortgage interest, state income tax, and charitable contributions. These personal expenses are allowable as itemized deductions. ■

Standard Deduction

In lieu of claiming itemized deductions, taxpayers will use the **standard deduction**. As discussed later in the chapter, the standard deduction varies depending on filing status, age, and blindness. Like personal and dependency exemptions (discussed later), the standard deduction is adjusted (i.e., indexed) each year for inflation.

Personal and Dependency Exemptions

Exemptions are allowed for the taxpayer, the taxpayer's spouse, and each dependent of the taxpayer. The exemption amount for both 2009 and 2010 is $3,650 as no adjustment for inflation was necessary for 2010.

Taxable Income

The determination of taxable income is illustrated below in Example 6.

Grace, age 25, is single and has her disabled and dependent mother living with her. Grace is a high school teacher and earned a $40,000 salary in 2010. Her other income consisted of $1,000 interest on a certificate of deposit (CD) and $500 of interest on municipal bonds that she had received as a graduation gift in 2007. During 2010, she sustained a deductible capital loss of $1,000. Her itemized deductions are $8,800. Grace's taxable income for the year is computed as follows:

Income (broadly conceived)		
Salary		$40,000
Interest on a CD		1,000
Interest on municipal bonds		500
Total income		$41,500
Less: Exclusion—		
Interest on municipal bonds		(500)
Gross income		$41,000
Less: Deduction *for* adjusted gross income—Capital loss		(1,000)
Adjusted gross income (AGI)		$40,000
Less: The *greater* of—		
Total itemized deductions	$8,800	
or the standard deduction for head of household	8,400	(8,800)
Less: Personal and dependency exemptions (2 × $3,650)		(7,300)
Taxable income		$23,900

■

Note that the exclusion of $500 (i.e., interest from municipal bonds) is deducted in determining gross income. The loss of $1,000 from a property

TABLE 16.1 Basic Standard Deduction Amounts

Filing Status	Standard Deduction Amount 2009	2010
Single	$ 5,700	$ 5,700
Married, filing jointly	11,400	11,400
Surviving spouse	11,400	11,400
Head of household	8,350	8,400
Married, filing separately	5,700	5,700

TABLE 16.2 Amount of Each Additional Standard Deduction

Filing Status	2009	2010
Single	$1,400	$1,400
Married, filing jointly	1,100	1,100
Surviving spouse	1,100	1,100
Head of household	1,400	1,400
Married, filing separately	1,100	1,100

transaction is classified as a deduction *for* AGI. Grace chose to itemize her deductions *from* AGI as they exceed the standard deduction (see Table 16.1 for the derivation of the $8,400 amount). Grace's income tax is determined later in this chapter in Example 32.

16.2 Standard Deduction

LO.2

Understand the standard deduction and evaluate its choice in arriving at taxable income.

A major component of the tax formula is the standard deduction. The effect of the standard deduction is to exempt part of a taxpayer's income from Federal income tax liability. In the past, Congress has attempted to set the tax-free amount represented by the standard deduction approximately equal to an estimated poverty level,[6] but it has not always been consistent in doing so.

BASIC AND ADDITIONAL STANDARD DEDUCTION

The standard deduction is the sum of two components: the *basic* standard deduction and the *additional* standard deduction.[7] Table 16.1 lists the basic standard deduction allowed for taxpayers in each filing status. All taxpayers allowed a *full* standard deduction are entitled to the applicable amount listed in Table 16.1. The standard deduction amounts are subject to adjustment for inflation each year. Except for the head-of-household filing status, no adjustment for inflation was necessary for 2010.

Certain taxpayers are not allowed to claim *any* standard deduction, and the standard deduction is *limited* for others. These provisions are discussed later in the chapter.

A taxpayer who is age 65 or over *or* blind qualifies for an *additional standard deduction* of $1,100 or $1,400, depending on filing status (see amounts in Table 16.2). Two

[6]S.Rep. No. 92–437, 92nd Cong., 1st Sess., 1971, p. 54. Another purpose of the standard deduction was discussed in Chapter 1 under Influence of the Internal Revenue Service—Administrative Feasibility. The size of the standard deduction has a direct bearing on the number of taxpayers who are in a position to itemize deductions. Reducing the number of taxpayers who itemize also reduces the audit effort required from the IRS.

[7]§ 63(c)(1).

additional standard deductions are allowed for a taxpayer who is age 65 or over *and* blind. The additional standard deduction provisions also apply for a qualifying spouse who is age 65 or over or blind, but a taxpayer may not claim an additional standard deduction for a dependent.

To determine whether to itemize, the taxpayer compares the *total* standard deduction (the sum of the basic standard deduction and any additional standard deductions) with total itemized deductions. Taxpayers are allowed to deduct the *greater* of itemized deductions or the standard deduction. Taxpayers whose itemized deductions are less than the standard deduction compute their taxable income using the standard deduction rather than itemizing. Approximately 63 percent of individual taxpayers choose the standard deduction option.

Sara, who is single, is 66 years old. She had itemized deductions of $6,800 during 2010. Her total standard deduction is $7,100 ($5,700 basic standard deduction plus $1,400 additional standard deduction). Sara should compute her taxable income for 2010 using the standard deduction ($7,100), since it exceeds her itemized deductions ($6,800). ■

REAL PROPERTY TAXES AND AUTO SALES TAXES STANDARD DEDUCTIONS

To stimulate home ownership in view of the housing downturn and mortgage crisis, Congress enacted a temporary standard deduction for real property taxes. Available for 2008 and 2009 tax returns, the new provision allows *nonitemizers* to claim real property taxes as a standard deduction. The amount allowed is the lesser of what was paid or $500 ($1,000 on a joint return).

Paul and Iris were recently married and purchased a home in October 2009. Their itemized deductions for the year (which include $1,100 in real property taxes) do not exceed the basic standard deduction. When they file their joint return for 2009, they can claim a standard deduction of $12,400 [$11,400 (basic standard deduction) + $1,000 (real property taxes standard deduction)]. ■

In order to promote the sales of automobiles, ARRTA of 2009 provides a new tax incentive. Subject to the conditions specified below, the sales tax paid on the purchase can be claimed as a special standard deduction.

- The deduction cannot exceed the part of the tax attributable to the first $49,500 of the purchase price.
- A phaseout of the deduction takes place when the taxpayer's AGI exceeds $125,000 ($250,000 on a joint return).
- The purchased vehicle (e.g., car, SUV, light truck, motorcycle) cannot exceed a gross weight of 8,500 pounds, and the original use must commence with the taxpayer.
- The purchase occurs from February 17 through December 31, 2009.

Although these new standard deductions are limited in duration (i.e., through 2009), congressional action to extend the provisions is to be expected if the current economic downturn continues. If taxpayers claim a standard deduction *other than* the basic or additional standard deductions (see Tables 16.1 and 16.2), a Schedule L (Standard Deduction for Certain Filers) must be completed. The result of Schedule L, a 21-line convoluted and complex procedure, is transferred to line 40b of Form 1040 (page 2).

Property taxes on a personal residence and sales taxes on a personal auto normally are deductions *from* AGI. Thus, the standard deductions alternative is a tax windfall for taxpayers who do not itemize. Unfortunately, the need to complete Schedule L (see prior discussion) eliminates one of the major advantages of choosing the standard deduction alternative—it is simpler and less time-consuming than itemizing.



In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

SPECIAL LIMITATIONS ON THE STANDARD DEDUCTION FOR DEPENDENTS

Special rules apply to the standard deduction and personal exemption of an individual who can be claimed as a dependent on another person's tax return.

When filing his or her own tax return, a *dependent's* basic standard deduction in 2010 is limited to the greater of $950 or the sum of the individual's earned income for the year plus $300.[8] However, if the sum of the individual's earned income plus $300 exceeds the normal standard deduction, the standard deduction is limited to the appropriate amount shown in Table 16.1. These limitations apply only to the basic standard deduction. A dependent who is 65 or over or blind or both is also allowed the additional standard deduction amount on his or her own return (refer to Table 16.2). These provisions are illustrated in Examples 9 through 12.

EXAMPLE 9

Susan, who is 17 years old and single, is claimed as a dependent on her parents' tax return. During 2010, she received $1,200 of interest (unearned income) on a savings account. She also earned $400 from a part-time job. When Susan files her own tax return, her standard deduction is $950 (the greater of $950 or the sum of earned income of $400 plus $300). ■

EXAMPLE 10

Assume the same facts as in Example 9, except that Susan is 67 years old and is claimed as a dependent on her son's tax return. In this case, when Susan files her own tax return, her standard deduction is $2,350 [$950 (the greater of $950 or the sum of earned income of $400 plus $300) + $1,400 (the additional standard deduction allowed because Susan is age 65 or over)]. ■

EXAMPLE 11

Peggy, who is 16 years old and single, earned $700 from a summer job and had no unearned income during 2010. She is claimed as a dependent on her parents' tax return. Her standard deduction is $1,000 (the greater of $950 or the sum of earned income of $700 plus $300). ■

EXAMPLE 12

Jack, who is a 20-year-old, single, full-time college student, is claimed as a dependent on his parents' tax return. He worked as a musician during the summer of 2010, earning $5,900. Jack's standard deduction is $5,700 (the greater of $950 or the sum of earned income of $5,900 plus $300, but limited to the $5,700 standard deduction for a single taxpayer). ■

16.3 PERSONAL EXEMPTIONS

LO.3

Apply the rules for arriving at personal exemptions.

The use of exemptions in the tax system is based in part on the idea that a taxpayer with a small amount of income should be exempt from income taxation. An exemption frees a specified amount of income from tax ($3,650 in 2009 and 2010). The exemption amount is indexed (adjusted) annually for inflation.

[8] § 63(c)(5). Both the $950 amount and the $300 amount are subject to adjustment for inflation each year. Neither amount was raised from that available in 2009 for 2010.

TABLE 16.3 Marital Status for Exemption Purposes

Description	Marital Status and Personal Exemptions
• Walt is the widower of Helen who died on January 3, 2010.	Walt and Helen are considered to be married for purposes of filing the 2010 return. Walt may claim two exemptions on his 2010 return.
• Bill and Jane entered into a divorce decree that becomes effective on December 31, 2010.	Bill and Jane are considered to be unmarried for purposes of filing the 2010 return. Bill and Jane each may claim a personal exemption on their separate returns.

Exemptions that are allowed for the taxpayer and spouse are designated as **personal exemptions**. Those exemptions allowed for the care and maintenance of other persons are called dependency exemptions and are discussed in the next section.

An individual cannot claim a personal exemption if he or she is claimed as a dependent by another.

EXAMPLE 13

Assume the same facts as in Example 12. On his own income tax return,[9] Jack's taxable income is determined as follows:

Gross income	$ 5,900
Less: Standard deduction	(5,700)
Personal exemption	(–0–)
Taxable income	$ 200

Note that Jack is not allowed a personal exemption because he is claimed as a dependent by his parents. ■

When a husband and wife file a joint return, they may claim two personal exemptions. However, when separate returns are filed, a married taxpayer cannot claim an exemption for his or her spouse *unless* the spouse has no gross income and is not claimed as the dependent of another taxpayer.[10]

The determination of marital status generally is made at the end of the taxable year, except when a spouse dies during the year. Spouses who enter into a legal separation under a decree of divorce or separate maintenance before the end of the year are considered to be unmarried at the end of the taxable year. Table 16.3 illustrates the effect of death or divorce upon marital status.

The amount of the exemption is not reduced due to the taxpayer's death. For example, refer to the case of Helen in Table 16.3. Although she lived for only three days in 2010, the full personal exemption of $3,650 is allowed for the tax year. The same rule applies to dependency exemptions. As long as an individual qualified as a dependent at the time of death, the full amount of the exemption can be claimed.

For *Federal* tax purposes, the law does not recognize same-sex marriages. By virtue of the Defense of Marriage Act (Pub. L. No. 104–199), a marriage means a legal union only between a man and a woman as husband and wife.

[9]As noted on page 16–20 of the text, Jack's situation is such that he will be required to file an income tax return.

[10]§ 151(b).

16.4 Dependency Exemptions

LO.4

Apply the rules for determining dependency exemptions.

As is the case with personal exemptions, a taxpayer is permitted to claim an exemption of $3,650 in 2009 and 2010 for each person who qualifies as a dependent. A **dependency exemption** is available for either a qualifying child or a qualifying relative and must not run afoul of certain other rules (i.e., joint return, nonresident alien prohibitions).

QUALIFYING CHILD

One of the objectives of the Working Families Tax Relief Act of 2004 was to establish a uniform definition of qualifying child. The qualifying child definition applies to the following tax provisions:

- Dependency exemption.
- Head-of-household filing status.
- Earned income tax credit.
- Child tax credit.
- Credit for child and dependent care expenses.

A **qualifying child** must meet the relationship, abode, age, and support tests.[11] For dependency exemption purposes, a qualifying child must also satisfy the joint return test and the citizenship or residency test.

Relationship Test

The relationship test includes a taxpayer's child (son, daughter), adopted child, stepchild, eligible foster child, brother, sister, half brother, half sister, stepbrother, stepsister, or a *descendant* of any of these parties (e.g., grandchild, nephew, niece). Note that *ancestors* of any of these parties (e.g., uncles and aunts) and in-laws (e.g., son-in-law, brother-in-law) *are not included.*

An adopted child includes a child lawfully placed with the taxpayer for legal adoption even though the adoption is not final. An eligible foster child is one who is placed with the taxpayer by an authorized placement agency or by a judgment decree or other order of any court of competent jurisdiction.

Abode Test

A qualifying child must live with the taxpayer for more than half of the year. For this purpose, temporary absences (e.g., school, vacation, medical care, military service, detention in a juvenile facility) are disregarded. Special rules apply in the case of certain kidnapped children.[12]

Age Test

A qualifying child must be under age 19 or under age 24 in the case of a student. A student is a child who, during any part of five months of the year, is enrolled full time at a school or government-sponsored on-farm training course.[13] Also, an individual cannot be older than the taxpayer claiming him or her as a qualifying child (e.g., a brother cannot claim his older sister as a qualifying child). The age test does not apply to a child who is disabled during any part of the year.[14]

Support Test

In order to be a qualifying child, the individual must not be self-supporting (i.e., provide more than one-half of his or her own support). In the case of a child who is a full-time student, scholarships are not considered to be support.[15]

[11] § 152(c).
[12] § 152(f)(6).
[13] § 152(f)(2).
[14] Within the meaning of § 22(e)(3) for purposes of the credit for the elderly or disabled.
[15] § 152(f)(5).

TABLE 16.4 Tiebreaker Rules for Claiming Qualifying Child

Persons Eligible to Claim Exemption	Person Prevailing
One of the persons is the parent.	Parent
Both persons are the parents, and the child lives longer with one parent.	Parent with the longer period of residence
Both persons are the parents, and the child lives with each the same period of time.	Parent with the higher adjusted gross income (AGI)
None of the persons is the parent.	Person with highest AGI

EXAMPLE 14

Shawn, age 23, is a full-time student and lives with his parents and an older cousin. During 2010, Shawn receives his support from the following sources: 30% from a part-time job, 30% from a scholarship, 20% from his parents, and 20% from the cousin. Shawn is not self-supporting and can be claimed by his parents as a dependent. (Note: Shawn cannot be a qualifying child as to his cousin due to the relationship test.) ■

Tiebreaker Rules

In some situations, a child may be a qualifying child to more than one person. In this event, the tax law specifies which person has priority in claiming the dependency exemption.[16] Called "tiebreaker rules," these rules are summarized in Table 16.4.

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft.**

2 DIGGING DEEPER

QUALIFYING RELATIVE

Besides establishing the concept of a qualifying child, the Working Families Tax Relief Act of 2004 also provided for a second category of dependency exemption designated as the **qualifying relative**.

A qualifying relative must meet the relationship, gross income, and support tests.[17] As in the case of the qualifying child category, qualifying relative status also requires that the joint return and nonresident alien restrictions be avoided (see Other Rules for Dependency Exemptions below).

Relationship Test

The relationship test for a qualifying relative is more expansive than for a qualifying child. Also included are the following relatives:

- Lineal ascendants (e.g., parents, grandparents).
- Collateral ascendants (e.g., uncles, aunts).
- Certain in-laws (e.g., son-, daughter-, father-, mother-, brother-, and sister-in-law).[18]

Children who do not satisfy the qualifying child definition may meet the qualifying relative criteria.

EXAMPLE 15

Inez provides more than half of the support of her son, age 20, who is neither disabled nor a full-time student. The son is not a qualifying child due to the age test, but is a qualifying relative if the gross income test is met. Consequently, Inez may claim a dependency exemption for her son. ■

[16] § 152(c)(4).
[17] § 152(d).
[18] Once established by marriage, in-law status continues to exist and survives divorce.

The relationship test also includes unrelated parties who live with the taxpayer (i.e., are members of the household). Member-of-the-household status is not available for anyone whose relationship with the taxpayer violates local law or anyone who was a spouse during any part of the year.[19] However, an ex-spouse can qualify as a member of the household in a year following that of the divorce.

As the relationship test indicates, the category designation of "qualifying relative" is somewhat misleading. As just noted, persons other than relatives can qualify as dependents. Furthermore, not all relatives will qualify—notice the absence of the "cousin" grouping.

EXAMPLE 14

Charles provides more than half of the support of a family friend who lives with him and a cousin who lives in another city. Presuming the gross income test is met, the family friend is a qualifying relative, but the cousin is not. ■

Gross Income Test

A dependent's gross income must be *less* than the exemption amount—$3,650 in 2009 and 2010. Gross income is determined by the income that is taxable. In the case of scholarships, for example, include the taxable portion (e.g., amounts received for room and board) and exclude the nontaxable portion (e.g., amounts received for books and tuition). See the discussion of scholarships later in the chapter.

EXAMPLE 15

Elsie provides more than half of the support of her son, Tom, who does not live with her. Tom, age 26, is a full-time student in medical school, earns $3,000 from a part-time job, and receives a $12,000 scholarship covering his tuition. Elsie may claim Tom as a dependent since he meets the gross income test and is a qualifying relative. (Note: Tom is not a qualifying child due to either the abode or the age test.) ■

EXAMPLE 16

Aaron provides more than half of the support of his widowed aunt, Myrtle, who does not live with him. Myrtle's income for the year is as follows: dividend income of $1,100, earnings from pet sitting of $1,200, Social Security benefits of $6,000, and interest from City of Milwaukee bonds of $8,000. Since Myrtle's gross income is only $2,300 ($1,100 + $1,200), she meets the gross income test and can be claimed as Aaron's dependent. ■

Support Test

Over one-half of the support of the qualifying relative must be furnished by the taxpayer. Support includes food, shelter, clothing, toys, medical and dental care, education, and the like. However, a scholarship (both taxable and nontaxable portions) received by a student is not included for purposes of determining whether the taxpayer furnished more than half of the child's support.

EXAMPLE 17

Hal contributed $3,400 (consisting of food, clothing, and medical care) toward the support of his nephew, Sam, who lives with him. Sam earned $1,500 from a part-time job and received a $2,000 scholarship to attend a local university. Assuming that the other dependency tests are met, Hal can claim Sam as a dependent since he has contributed more than half of Sam's support. The $2,000 scholarship is not included as support for purposes of this test. ■

If an individual does not spend funds that have been received from any source, the unspent amounts are not counted for purposes of the support test.

[19] §§ 152(d)(2)(H) and (f)(3).

Emily contributed $3,000 to her father's support during the year. In addition, her father received $2,400 in Social Security benefits, $200 of interest, and wages of $600. Her father deposited the Social Security benefits, interest, and wages in his own savings account and did not use any of the funds for his support. Thus, the Social Security benefits, interest, and wages are not considered to be support provided by Emily's father. Emily may claim her father as a dependent if the other tests are met. ■

An individual's own funds, however, must be taken into account if applied toward support. In this regard, the source of the funds so used is immaterial.

Frank contributes $8,000 toward his parents' total support of $20,000. The parents, who do not live with Frank, obtain the other $12,000 from savings and a home equity loan on their residence. Although the parents have no income, their use of savings and borrowed funds are counted as part of their support. Because Frank does not satisfy the support test, he cannot claim his parents as dependents. ■

Capital expenditures for items such as furniture, appliances, and automobiles are included for purposes of the support test if the item does, in fact, constitute support.

Norm purchased a television set costing $650 and gave it to his mother who lives with him. The television set was placed in the mother's bedroom and was used exclusively by her. Norm should include the cost of the television set in determining the support of his mother. ■

Multiple Support Agreements An exception to the support test involves a **multiple support agreement.** A multiple support agreement permits one of a group of taxpayers who furnish support for a qualifying relative to claim a dependency exemption for that individual even if no one person provides more than 50 percent of the support.[20] The group together must provide more than 50 percent of the support. Any person who contributed *more than 10 percent* of the support is entitled to claim the exemption if each person in the group who contributed more than 10 percent files a written consent. This provision frequently enables one of the children of aged dependent parents to claim an exemption when none of the children meets the 50 percent support test.

Each person who is a party to the multiple support agreement must meet all other requirements (except the support requirement) for claiming the exemption. A person who does not meet the relationship or member-of-the-household test, for instance, cannot claim the dependency exemption under a multiple support agreement. It does not matter if he or she contributes more than 10 percent of the individual's support.

Wanda, who resides with her son, Adam, received $12,000 from various sources during the year. This constituted her entire support for the year. She received support from the following individuals:

	Amount	Percentage of Total
Adam, a son	$ 5,760	48
Bob, a son	1,200	10
Carol, a daughter	3,600	30
Diane, a friend	1,440	12
	$12,000	100

[20] § 152(d)(3).

If Adam and Carol file a multiple support agreement, either may claim the dependency exemption for Wanda. Bob may not claim Wanda because he did not contribute more than 10% of her support. Bob's consent is not required in order for Adam and Carol to file a multiple support agreement. Diane does not meet the relationship or member-of-the-household test and cannot be a party to the agreement. The decision as to who claims Wanda rests with Adam and Carol. It is possible for Carol to claim Wanda, even though Adam furnished more of Wanda's support. ■



In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

Tax Planning Strategies **MULTIPLE SUPPORT AGREEMENTS AND THE MEDICAL EXPENSE DEDUCTION**

FRAMEWORK FOCUS: DEDUCTIONS

Strategy: Maximize Deductible Amounts.

Generally, medical expenses are deductible only if they are paid on behalf of the taxpayer, his or her spouse, and their dependents.[21] Since deductibility may rest on dependency status, planning is important in arranging multiple support agreements.

During the year, Zelda will be supported by her two sons (Vern and Vito) and her daughter (Maria). Each will furnish approximately one-third of the required support. If the parties decide that the dependency exemption should be claimed by Maria under a multiple support agreement, any medical expenses incurred by Zelda should be paid by Maria. ■

In planning a multiple support agreement, take into account which of the parties is most likely to exceed the 7.5 percent limitation. In Example 24, for instance, Maria might be a poor choice if she and her family do not expect to incur many medical expenses of their own.

Children of Divorced or Separated Parents Another exception to the support test applies when parents with children are divorced or separated under a decree of separate maintenance. For unmarried parents, living apart (for the last six months of the year) will suffice. Special rules apply if the parents meet the following conditions:

- They would have been entitled to the dependency exemption(s) had they been married and filed a joint return.
- They have custody (either jointly or singly) of the child (or children) for more than half of the year.

Under the general rule, the parent having custody of the child (children) for the greater part of the year (i.e., the custodial parent) is entitled to the dependency exemption(s). The general rule does not apply if a multiple support agreement is in effect. It also does not apply if the custodial parent issues a waiver in favor of the noncustodial parent.[22]



In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

[21]See the discussion of medical expenses later in this chapter.

[22]See Reg. § 1.152–4T and §§ 152(e)(2) and (5).

OTHER RULES FOR DEPENDENCY EXEMPTIONS

In addition to fitting into either the qualifying child or the qualifying relative category, a dependent must meet the joint return and the citizenship or residency tests.

Joint Return Test

If a dependent is married, the supporting taxpayer (e.g., the parent of a married child) generally is not permitted a dependency exemption if the married individual files a joint return with his or her spouse.[23] The joint return rule does not apply, however, if the following conditions are met:

- The reason for filing is to claim a refund for tax withheld.
- No tax liability would exist for either spouse on separate returns.
- Neither spouse is required to file a return.

EXAMPLE 31

Paul provides over half of the support of his son, Quinn. He also provides over half of the support of Vera, who is Quinn's wife. During the year, both Quinn and Vera had part-time jobs. To recover the taxes withheld, they file a joint return. If Quinn and Vera have income low enough that they are not *required* to file a return, Paul is allowed to claim both as dependents. ■

Tax Planning Strategies PROBLEMS WITH A JOINT RETURN

FRAMEWORK FOCUS: DEDUCTIONS

Strategy: Maximize Deductible Amounts.

A married person who files a joint return generally cannot be claimed as a dependent by another taxpayer. If a joint return has been filed, the damage may be undone if separate returns are substituted on a timely basis (on or before the due date of the return).

EXAMPLE 32

While preparing a client's 2009 income tax return on April 2, 2010, a tax practitioner discovered that the client's daughter had filed a joint return with her husband in late January of 2010. Presuming the daughter otherwise qualifies as the client's dependent, the exemption is not lost if she and her husband file separate returns on or before April 15, 2010. ■

Citizenship or Residency Test

To be a dependent, the individual must be either a U.S. citizen, a U.S. resident, or a resident of Canada or Mexico for some part of the calendar year in which the taxpayer's tax year begins.[24]

COMPARISON OF CATEGORIES FOR DEPENDENCY EXEMPTIONS

Concept Summary 16.1 sets forth the tests for the two categories of dependency exemptions. In contrasting the two categories, the following observations are in order:

- As to the relationship tests, the qualifying relative category is considerably more expansive. Besides including those prescribed under the qualifying child grouping, other relatives are added. Nonrelated persons who are members of the household are also included.
- The support tests are entirely different. In the case of a qualifying child, support is not necessary. What is required is that the child not be self-supporting.

[23] § 152(b)(2).

[24] § 152(b)(3).

CONCEPT SUMMARY 16.1

Tests for Dependency Exemption

Category	
Qualifying Child	**Qualifying Relative**[1]
Relationship[2]	Support
Abode[3]	Relationship[4] or member of household[3]
Age	Gross income
Support	Joint return[5]
Joint return[5]	Citizenship or residency[6]
Citizenship or residency[6]	

[1] These rules are largely the same as those applicable to pre-2005 years.
[2] Children and their descendants, and siblings and stepsiblings and their descendants.
[3] The rules for abode are the same as for member of the household.
[4] Children and their descendants, siblings and their children, parents and their ascendants, uncles and aunts, stepparents and stepsiblings, and certain in-laws.
[5] The joint return rules are the same for each category.
[6] The citizenship or residency rules are the same for each category.

- The qualifying child category has no gross income limitation, whereas the qualifying relative category has no age restriction.

PHASEOUT OF EXEMPTIONS

Is there any reason why certain higher-income taxpayers should be denied some or all of the tax benefits of being able to claim as a deduction personal and dependency exemptions? Apparently, Congress originally thought so and enacted legislation that phased out any such deduction in stages. Congress later changed its mind and reduced the phaseout. Thus, during this period of indecisiveness in the tax law, higher-bracket taxpayers experienced years when they were losing their exemptions followed by years when the exemptions were being restored. As of 2010, the restoration is complete, and all taxpayers, regardless of income level, may *fully* deduct any personal and dependency exemptions to which they are entitled.[25]

What does this past history of phaseouts portend for the future? In this period of budget crisis when new sources of revenue are at a premium, high-income taxpayers will be highly vulnerable. A reenactment by Congress of the phaseouts on personal and dependency exemptions would not be a surprise.

16.5 Tax Determination—Filing Considerations

LO.5
Be aware of the filing requirements and choose the proper filing status.

Once taxable income has been ascertained, a two-step process is used in determining income tax due (or refund available). First, certain procedural matters must be resolved. Second, the tax has to be computed and adjusted for available tax credits—see Figure 16.1 and the tax formula. This section deals with the procedural aspects—designated as filing considerations. The section to follow covers the computation procedures.

[25] The phaseouts and their later reduction are clearly set forth in § 151(d)(3).

TAX in the NEWS

How to Subtly Pluck the Chicken

No government likes to admit that it is enacting new taxes or even raising the rates on existing taxes. Needless to say, this is particularly true of the U.S. Congress. But there are more subtle ways to raise revenue (or to curtail revenue loss). The most popular way is to use a so-called *stealth tax*. A stealth tax is not really a tax at all. Instead, it is a means of depriving higher-income taxpayers of the benefits of certain tax provisions thought to be available to all.

The heart and soul of the stealth tax is the phaseout approach. Thus, as income increases, the tax benefit thought to be derived from a particular relief provision decreases. Since the phaseout usually is gradual and not drastic, many affected taxpayers are unaware of what has happened.

The tax law is rampant with phaseouts. The following are a few notable examples of these stealth taxes, each of which is discussed in this chapter:

- Earned income credit.
- Child tax credit.
- Interest deduction on student loans.
- American Opportunity college credit.

As mentioned on page 16–18, personal and dependency exemptions were once denied to higher-bracket taxpayers on a phaseout basis.

Under the category of filing considerations, the following questions need to be resolved:

- Is the taxpayer required to file an income tax return?
- If so, which form should be used?
- When and how should the return be filed?
- What is the taxpayer's filing status?

FILING REQUIREMENTS

General Rules

An individual must file a tax return if certain minimum amounts of gross income have been received. The general rule is that a tax return is required for every individual who has gross income that equals or exceeds the sum of the exemption amount plus the applicable standard deduction.[26] For example, a single taxpayer under age 65 must file a tax return in 2010 if gross income equals or exceeds $9,350 ($3,650 exemption plus $5,700 standard deduction).[27]

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

5 DIGGING DEEPER

The additional standard deduction for being age 65 or older is considered in determining the gross income filing requirements. For example, the 2010 filing requirement for a single taxpayer age 65 or older is $10,750 ($5,700 basic standard deduction + $1,400 additional standard deduction + $3,650 exemption).

A self-employed individual with net earnings of $400 or more from a business or profession must file a tax return regardless of the amount of gross income.

Even though an individual has gross income below the filing level amounts and therefore does not owe any tax, he or she must file a return to obtain a tax refund of amounts withheld. A return is also necessary to obtain the benefits of the earned income credit allowed to taxpayers with little or no tax liability.

[26]The gross income amounts for determining whether a tax return must be filed are adjusted for inflation each year.

[27]§ 6012(a)(1).

Filing Requirements for Dependents

Computation of the gross income filing requirement for an individual who can be claimed as a dependent on another person's tax return is subject to more complex rules. For example, such an individual must file a return if he or she has earned income only and gross income that is more than the total standard deduction (including any additional standard deduction) that the individual is allowed for the year.



In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

Selecting the Proper Form

Although a variety of forms are available to individual taxpayers, the use of some of these forms is restricted. For example, Form 1040EZ cannot be used if:

- Taxpayer claims any dependents;
- Taxpayer (or spouse) is 65 or older or blind; or
- Taxable income is $100,000 or more.

Taxpayers who desire to itemize deductions *from* AGI cannot use Form 1040A, but must file Form 1040 (the long form).

The E-File Approach

In addition to traditional paper returns, the **e-file** program is an increasingly popular alternative. Here, the required tax information is transmitted to the IRS electronically either directly from the taxpayer (i.e., an "e-file online return") or indirectly through an electronic return originator (ERO). EROs are tax professionals who have been accepted into the electronic filing program by the IRS. Such parties hold themselves out to the general public as "authorized IRS e-file providers." Providers often are also the preparers of the return.

Through prearrangement with the IRS, some providers offer free e-filing services. Generally, such services are available only to lower-income taxpayers (e.g., below $56,000) and if other specified conditions are satisfied. A list of these providers and their eligibility requirements can be obtained through the IRS website.

The e-file approach has two major advantages. First, compliance with the format required by the IRS eliminates many errors that would otherwise occur. Second, the time required for processing a refund usually is reduced to three weeks or less.

When and Where to File

Tax returns of individuals are due on or before the fifteenth day of the fourth month following the close of the tax year. For the calendar year taxpayer, the usual filing date is on or before April 15 of the following year.[28] When the due date falls on a Saturday, Sunday, or legal holiday, the last day for filing falls on the next business day.

If a taxpayer is unable to file the return by the specified due date, a six-month extension of time can be obtained by filing Form 4868 (Application for Automatic Extension of Time to File U.S. Individual Income Tax Return).[29]

Although obtaining an extension excuses a taxpayer from a penalty for failure to file, it does not insulate against the penalty for failure to pay. If more tax is owed, the filing of Form 4868 should be accompanied by an additional remittance to cover the balance due. The return should be sent or delivered to the Regional Service Center listed in the instructions for each type of return or contained in software applications.[30]

[28] § 6072(a).
[29] Reg. § 1.6081–4.
[30] The Regional Service Centers and the geographic area each covers can also be found at **www.irs.gov/file** or in tax forms packages.



What Form of Tax Compliance Is Right for You?

Based on recent projections from the IRS, when preparing nearly 139 million individual income tax returns expected to be filed in 2011, taxpayers will be using relatively fewer paper Forms 1040, 1040A, and 1040EZ. As a result, the IRS expects the level of electronically filed returns to be at an all-time high.

	Percentage
Paper individual returns	27.15
Electronically filed individual returns	72.85
	100.00

Source: Fiscal Year Return Projections for the United States: 2009–2016, IRS, Document 6292, Spring 2009 Update, Table 1.

Mode of Payment

Usually, payment is made by check. However, the IRS has approved the use of MasterCard, American Express, Discover, and Visa to pay Federal taxes. The use of a credit card to pay taxes will result in a charge against the cardholder by the credit card company.

FILING STATUS

The amount of tax will vary considerably depending on which Tax Rate Schedule is used. This is illustrated in the following example.

EXAMPLE 17

The following amounts of tax are computed using the 2010 Tax Rate Schedules for a taxpayer (or taxpayers in the case of a joint return) with $60,000 of taxable income (see Appendix A).

Filing Status	Amount of Tax
Single	$11,181
Married, filing joint return	8,163
Married, filing separate return	11,181
Head of household	9,848

■

Besides the effect on the tax rates that will apply, filing status also has an impact on the amount of the standard deduction that is allowed—see Tables 16.1 and 16.2 earlier in the chapter.

Single Taxpayers

A taxpayer who is unmarried or separated from his or her spouse by a decree of divorce or separate maintenance and does not qualify for another filing status must use the rates for single taxpayers. Marital status is determined as of the last day of the tax year, except when a spouse dies during the year. In that case, marital status is determined as of the date of death.

Married Individuals

The joint return was originally enacted to establish equity between married taxpayers in common law states and those in community property states. Before the joint return rates were enacted, taxpayers in community property states were in an

Bridge DISCIPLINE

Bridge to Equity or Fairness

Much has been made in the press and in political circles in recent years concerning the so-called marriage penalty tax. This marriage penalty refers to the additional income tax that married couples pay over and above the aggregate amount two single individuals would pay with equal amounts of income. The marriage penalty arose because of the nature of the income tax rate structure that applies to individual taxpayers.

Relevant policy and ethical issues related to this dilemma are:

- Should the income tax system contain a bias against marriage?
- Should the income tax system require two people of economic means equal to that of two other people to pay a different amount of income taxes?
- Should the income tax system encourage two individuals to cohabit outside the commitment of marriage?

Long aware of the inequity of the marriage penalty, Congress reduced the effect of the problem with tax legislation in 2003. Beginning in 2003, the standard deduction available to married filers increased to 200 percent of that applicable to single persons. Furthermore and also beginning in 2003, the 15 percent bracket for joint filers increased to 200 percent of the size of that applicable to single filers.

advantageous position relative to taxpayers in common law states because they could split their income.

Taxpayers in common law states did not have this income-splitting option, so their taxable income was subject to higher marginal rates. This inconsistency in treatment was remedied by the joint return provisions. The progressive rates in the joint return Tax Rate Schedule are constructed based on the assumption that income is earned equally by the two spouses.

If married individuals elect to file separate returns, each reports only his or her own income, exemptions, deductions, and credits, and each must use the Tax Rate Schedule applicable to married taxpayers filing separately. It is generally advantageous for married individuals to file a joint return, since the combined amount of tax is lower. However, special circumstances (e.g., significant medical expenses incurred by one spouse subject to the 7.5 percent limitation) may warrant the election to file separate returns. It may be necessary to compute the tax under both assumptions to determine the most advantageous filing status.

Marriage Penalty When Congress enacted the rate structure available to those filing joint returns, it generally favored married taxpayers. In certain situations, however, the parties would incur less tax if they were not married and filed separate returns. The additional tax that a joint return caused, commonly called the **marriage penalty**, usually developed when *both* spouses had large taxable incomes.

DIGGING DEEPER 7

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

Surviving Spouse The joint return rates also apply for two years following the death of one spouse, if the surviving spouse maintains a household for a dependent child. The child must be a son, stepson, daughter, or stepdaughter who qualifies as a dependent of the taxpayer. This is referred to as **surviving spouse** status.[31]

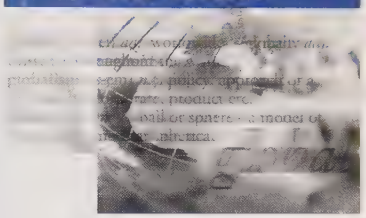
Head of Household

Unmarried individuals who maintain a household for a dependent (or dependents) are generally entitled to use the **head-of-household** rates.[32] The tax liability using the

[31] § 2(a). The IRS label for surviving spouse status is "qualifying widow(er) with dependent child."

[32] § 2(b).

GLOBAL *Tax Issues*



Filing a Joint Return

John Garth is a U.S. citizen and resident, but he spends a lot of time in London where his employer sends him on frequent assignments. John is married to Victoria, a citizen and resident of the United Kingdom.

Can John and Victoria file a joint return for U.S. Federal income tax purposes? Although § 6013(a)(1) specifically precludes the filing of a joint return if one spouse is a nonresident alien, another Code provision permits an exception. Under § 6013(g), the parties can elect to treat the nonqualifying spouse as a "resident" of the United States. This election would allow John and Victoria to file jointly.

But should John and Victoria make this election? If Victoria has considerable income of her own (from non-U.S. sources), the election could be ill-advised. As a nonresident alien, Victoria's non-U.S. source income *would not* be subject to the U.S. income tax. If she is treated as a U.S. resident, however, her non-U.S. source income *will be subject to U.S. tax.* Under the U.S. global approach to taxation, all income (regardless of where earned) of anyone who is a *resident* or *citizen* of the United States is subject to tax.

head-of-household rates falls between the liability using the joint return Tax Rate Schedule and the liability using the Tax Rate Schedule for single taxpayers.

To qualify for head-of-household rates, a taxpayer must pay more than half the cost of maintaining a household as his or her home. The household must also be the principal home of a dependent. Except for temporary absences (e.g., school, hospitalization), the dependent must live in the taxpayer's household for over half the year.

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft.**

8 DIGGING DEEPER

Abandoned Spouse Rules

Congress has enacted provisions that allow married taxpayers, commonly referred to as abandoned spouses, to file as a head of household if the following conditions are satisfied:

- The taxpayer does not file a joint return.
- The taxpayer paid more than one-half the cost of maintaining his or her home for the tax year.
- The taxpayer's spouse did not live in the home during the last six months of the tax year.
- The home was the principal residence of the taxpayer's son, daughter, stepson, stepdaughter, foster child, or adopted child for more than half the year, and the child can be claimed as a dependent.

The resulting tax burden using the relatively favorable head-of-household status is lower than when using the married filing separately rate schedule.

16.6 Tax Determination—Computation Procedures

LO.6

Use the proper procedures for determining the tax liability.

The computation of income tax due (or refund) involves applying the proper set of tax rates to taxable income and then adjusting for available credits. In certain cases, however, the application of the kiddie tax will cause a modification of the means by which the tax is determined.

TABLE 16.5 2010 Tax Rate Schedule for Single Taxpayers

If Taxable Income Is Over	But Not Over	The Tax Is:	Of the Amount Over
$ –0–	$ 8,375	10%	$ –0–
8,375	34,000	$ 837.50 + 15%	8,375
34,000	82,400	4,681.25 + 25%	34,000
82,400	171,850	16,781.25 + 28%	82,400
171,850	373,650	41,827.25 + 33%	171,850
373,650		108,421.25 + 35%	373,650

TAX TABLE METHOD

The tax liability is computed using either the Tax Table method or the Tax Rate Schedule method. Most taxpayers compute their tax using the **Tax Table**. Eligible taxpayers compute taxable income (as shown in Figure 16.1) and *must* determine their tax by reference to the Tax Table.[33]

DIGGING DEEPER 9

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

Although the Tax Table is derived by using the Tax Rate Schedules (discussed below), the tax calculated using the two methods may vary slightly. This variation occurs because the tax for a particular income range in the Tax Table is based on the midpoint amount.

EXAMPLE 28

Linda is single and has taxable income of $30,000 for calendar year 2009. To determine Linda's tax using the Tax Table (see Appendix A), find the $30,000 to $30,050 income line. The tax of $4,086 is actually the tax the Tax Rate Schedule would yield on taxable income of $30,025 (i.e., the midpoint amount between $30,000 and $30,050). ■

TAX RATE SCHEDULE METHOD

The 2010 rate schedule for single taxpayers is reproduced in Table 16.5.[34] This schedule is used to illustrate the tax computations in Examples 29 and 30.

EXAMPLE 29

Pat is single and had $5,870 of taxable income in 2010. His tax is $587 ($5,870 × 10%). ■

Several terms are used to describe tax rates. The rates in the Tax Rate Schedules are often referred to as *statutory* (or nominal) rates. The *marginal* rate is the highest rate that is applied in the tax computation for a particular taxpayer. In Example 29, the statutory rate and the marginal rate are both 10 percent.

EXAMPLE 30

Chris is single and had taxable income of $90,000 in 2010. Her tax is $18,909.25 [$16,781.25 + 28%($90,000 – $82,400)]. ■

The *average* rate is equal to the tax liability divided by taxable income. In Example 30, Chris has statutory rates of 10 percent, 15 percent, 25 percent, and 28 percent,

[33]The 2010 Tax Table was not available from the IRS at the date of publication of this text. The Tax Table for 2009 is located at **www.cengage.com/taxation/swft** and is used to illustrate this computation.

[34]Individual tax rates are found in § 1.

and a marginal rate of 28 percent. Chris's average rate is 21 percent ($18,909.25 tax liability ÷ $90,000 taxable income).

A tax is *progressive* (or graduated) if a higher rate of tax applies as the tax base increases. The progressive nature of the Federal income tax on individuals is illustrated by computing the tax in Example 30 utilizing each rate bracket.

Tax on first $8,375 at 10%	$ 837.50
Tax on $34,000 – $8,375 at 15%	3,843.75
Tax on $82,400 – $34,000 at 25%	12,100.00
Tax on $90,000 – $82,400 at 28%	2,128.00
Total tax on taxable income of $90,000	$18,909.25

A special computation limits the effective tax rate on qualified dividends (see Chapter 4) and net long-term capital gain (see Chapter 8).

Tax Planning Strategies **SHIFTING INCOME AND DEDUCTIONS ACROSS TIME**

FRAMEWORK FOCUS: TAX RATE

Strategy: Shift Net Income from High-Bracket Years to Low-Bracket Years.

It is natural for taxpayers to be concerned about the tax rates they are paying. How does a tax practitioner communicate information about rates to clients? There are several possibilities. For example, a taxpayer who is in the 15 percent bracket this year and expects to be in the 28 percent bracket next year should, if possible, defer payment of deductible expenses until next year to maximize the tax benefit of the deduction.

A note of caution is in order with respect to shifting income and expenses between years. Congress has recognized the tax planning possibilities of such shifting and has enacted many provisions to limit a taxpayer's ability to do so. Some of these limitations on the shifting of income and deductions are discussed in Chapters 4 through 6.

COMPUTATION OF NET TAXES PAYABLE OR REFUND DUE

The pay-as-you-go feature of the Federal income tax system requires payment of all or part of the taxpayer's income tax liability during the year. These payments take the form of Federal income tax withheld by employers or estimated tax paid by the taxpayer or both.[35] The payments are applied against the tax from the Tax Table or Tax Rate Schedules to determine whether the taxpayer will get a refund or pay additional tax.

Employers are required to withhold income tax on compensation paid to their employees and to pay this tax over to the government. The employer notifies the employee of the amount of income tax withheld on Form W–2 (Wage and Tax Statement). The employee should receive this form by January 31 after the year in which the income tax is withheld.

If taxpayers receive income that is not subject to withholding or income from which insufficient tax is withheld, they may have to pay estimated tax. These individuals must file Form 1040–ES (Estimated Tax for Individuals) and pay in quarterly installments the income tax and self-employment tax estimated to be due.

The income tax from the Tax Table or the Tax Rate Schedules also is reduced by the individual's tax credits. There is an important distinction between tax credits and tax deductions. Tax credits (including tax withheld) reduce the tax liability dollar-for-dollar. Tax deductions reduce taxable income on which the tax liability is based.

[35]See § 3402 for withholding and § 6654 for estimated payments.

TAX IN THE NEWS

THE TIGHTENING TAX SQUEEZE

How has the total tax burden changed over time? Many Americans would likely assert that more of their income than ever goes just to pay taxes. The Tax Foundation contends that such assertion is correct. It reports that the percentage of income claimed by Federal, state, and local taxes has increased from 5.9 percent in 1900 to 28.2 percent in 2009.

Source: Tax Foundation, 2009.

EXAMPLE 32

Gail is a taxpayer in the 25% tax bracket. As a result of incurring $1,000 in child care, she is entitled to a $200 credit for child and dependent care expenses ($1,000 child care expenses × 20% credit rate). She also contributed $1,000 to the American Cancer Society and included this amount in her itemized deductions. The credit for child and dependent care expenses results in a $200 reduction of Gail's tax liability for the year. The contribution to the American Cancer Society reduces taxable income by $1,000 and results in a $250 reduction in Gail's tax liability ($1,000 reduction in taxable income × 25% tax rate). ■

Selected tax credits for individuals are discussed later in this chapter. The following are some of the more common credits available to individuals:

- Child tax credit.
- Credit for child and dependent care expenses.
- Earned income credit.

The computation of net taxes payable or refund due can be illustrated by returning to the facts of Example 6.

EXAMPLE 33

Grace is single and has her disabled and dependent mother living with her. Recall that Example 6 established that she has taxable income of $23,900. Further assume that Grace has the following income tax withheld, $2,300; estimated tax payments, $600; and credit for dependent care expenses, $200. Grace's net tax payable (refund due) is computed as follows:

Income tax (from 2010 Tax Rate Schedule for head of household)		$ 2,988 (rounded)
Less: Tax credits and prepayments—		
Credit for dependent care expenses	$ 200	
Income tax withheld	2,300	
Estimated tax payments	600	(3,100)
Net taxes payable (refund due if negative)		($ 112)

■

LO.7

Identify and report kiddie tax situations.

KIDDIE TAX—UNEARNED INCOME OF CHILDREN TAXED AT PARENTS' RATE

Most individuals compute taxable income using the tax formula shown in Figure 16.1. Special provisions govern the computation of taxable income and the tax liability for certain children who have **unearned income** in excess of specified amounts.

Recall that individuals who are claimed as dependents by other taxpayers cannot claim an exemption on their own return. This prevents parents from shifting the tax on investment income (such as interest and dividends) to a child by transferring ownership of the assets producing the income. Without this provision, the child would pay no tax on the income to the extent that it was sheltered by the child's exemption and standard deduction amounts.

Current tax law also reduces or eliminates the possibility of saving taxes by shifting income from parents to children by taxing the net unearned income of these children as if it were the parents' income. Unearned income includes such income as taxable interest, dividends, capital gains, rents, royalties, pension and annuity income, and income (other than earned income) received as the beneficiary of a trust.

This provision, commonly referred to as the **kiddie tax**, applies to any child who is under age 19 (or under age 24 if a full-time student) and has unearned income of more than $1,900.[36] The kiddie tax does not apply if the child has earned income that exceeds half of his or her support, if the child is married and files a joint return, or if both parents are deceased.

Net Unearned Income

Net unearned income of a dependent child is computed as follows:

Unearned income
Less: $950
Less: The *greater* of
  $950 of the standard deduction *or*
  The amount of allowable itemized deductions directly connected with the production of the unearned income
Equals: Net unearned income

If net unearned income is zero (or negative), the child's tax is computed without using the parents' rate. If the amount of net unearned income (regardless of source) is positive, the net unearned income will be taxed at the parents' rate. The $950 amounts in the preceding formula are subject to adjustment for inflation each year.

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.



Election to Report Certain Unearned Income on Parents' Return

If a child who is subject to the kiddie tax is required to file a tax return and meets all of the following requirements, the parents may elect to report the child's unearned income that exceeds $1,900 on the parents' own tax return:

- Gross income is from interest and dividends only.
- Gross income is more than $950 but less than $9,500.
- No estimated tax has been paid in the name and Social Security number of the child, and the child is not subject to backup withholding.

If the parental election is made, the child is treated as having no gross income and then is not required to file a tax return. The parental election is made by completing and filing Form 8814 (Parents' Election to Report Child's Interest and Dividends).

[36] § 1(g)(2).

Tax Planning Strategies INCOME OF CERTAIN CHILDREN

FRAMEWORK FOCUS: TAX RATE

Strategy: Shift Net Income from High-Bracket Taxpayers to Low-Bracket Taxpayers.

Taxpayers can use several strategies to avoid or minimize the effect of the rules that tax the unearned income of certain children at the parents' rate. With the recent increase in the cutoff age from 18 to 19 (under 24 for full-time students), more minors will be vulnerable to the application of the kiddie tax. Parents should consider giving a younger child assets that defer the inclusion in gross income until the child reaches a nonvulnerable age. For example, U.S. government Series EE savings bonds can be used to defer income until the bonds are cashed in.

Growth stocks typically pay little in the way of dividends. However, the unrealized appreciation on an astute investment may more than offset the lack of dividends. The child can hold the growth stock until he or she reaches a safe age. If the stock is sold then at a profit, the profit is taxed at the child's low rates.

Taxpayers in a position to do so can employ their children in their business and pay them a reasonable wage for the work they actually perform (e.g., light office help, such as filing). The child's earned income is sheltered by the standard deduction, and the parents' business is allowed a deduction for the wages. The kiddie tax rules have no effect on earned income, even if it is earned from the parents' business.

The parent(s) must also pay an additional tax equal to the smaller of $95 or 10 percent of the child's gross income over $950. Parents who have substantial itemized deductions based on AGI may find that making the parental election increases total taxes for the family unit. Taxes should be calculated both with the parental election and without it to determine the appropriate choice.

16.7 OVERVIEW OF INCOME PROVISIONS APPLICABLE TO INDIVIDUALS

LO.8

Identify specific inclusions and exclusions applicable to individuals.

As indicated earlier in this chapter, the definition of gross income is broad enough to include almost all receipts of money, property, or services. However, the tax law provides for exclusion of many types of income.[37] The following income provisions, which apply to all taxpayers (including individuals), were discussed in Chapter 4:

- Interest from state and local bonds.
- Life insurance paid on death of the insured.
- Imputed interest on below-market loans.
- Income from discharge of indebtedness.
- Income included under the tax benefit rule.

Most *exclusions* available only to individuals are for *fringe benefits* received by *employees* (refer to Exhibit 16.1). Fringe benefits are discussed in Chapter 17. Other specific inclusions and exclusions for individuals are discussed below.

16.8 SPECIFIC INCLUSIONS APPLICABLE TO INDIVIDUALS

The general principles of gross income determination as applied by the IRS and the courts have on occasion yielded results Congress found unacceptable. Consequently, Congress has provided more specific rules for determining the amount of gross

[37] See §§ 101–140.



Bridge to Economics and Finance

As is the case for business entities, a primary financial goal for individual taxpayers should entail maximizing the *after-tax value* of their assets over time. This approach requires not only selecting the best investment alternatives, but also choosing those investments with the most favorable tax attributes. Fundamental to this notion is recognizing the key role that the government plays in all economic activity through its taxing authority. As a result, an investor should consider economically sound strategies that minimize the extent to which the government can stake a claim to his or her success. For example, taxpayers can reduce the government's share of their wealth accumulations by deferring the payment of taxes until future years and by taking advantage of investment strategies for which tax incentives are available. Taxpayers should choose the investment alternatives that provide the best after-tax return over time and not necessarily the ones that lead to the least amount of taxation.

These points can be illustrated by examining two classic strategies. One of the best ways for individuals to maximize their personal wealth is to invest to the extent possible in qualified retirement savings programs [e.g., traditional Individual Retirement Accounts, § 401(k) accounts]. Not only do current additions to such accounts provide a current tax deduction, but earnings within the account are not subject to taxation until they are withdrawn, which, in most cases, is during the retirement years of the owner. Postponing the tax in these two ways reduces the present value of the tax cost, which increases the after-tax value of the investment. Another strategy involves investing in tax-free municipal bonds, which produce interest income that is free of Federal income tax. The returns from such investments, however, should be compared with the after-tax returns flowing from available taxable debt securities. For example, a relevant question is how the implicit tax (see Chapter 1) associated with a municipal bond compares with the explicit tax associated with a taxable bond.

income from certain sources. Some of these special rules appear in §§ 71–90 of the Code. The following provisions applicable to individuals are covered in this chapter:

- Alimony and separate maintenance payments.
- Prizes and awards.
- Unemployment compensation.
- Social Security benefits.

ALIMONY AND SEPARATE MAINTENANCE PAYMENTS

When a married couple divorce or become legally separated, state law generally requires a division of the property accumulated during the marriage. In addition, one spouse may have a legal obligation to support the other spouse. The Code distinguishes between the support payments (alimony or separate maintenance) and the property division in terms of the tax consequences.

Alimony and separate maintenance payments are deductible by the party making the payments and are includible in the gross income of the party receiving the payments.[38] Thus, taxation of the income is shifted from the income earner to the income beneficiary.

EXAMPLE 30

Pete and Tina are divorced, and Pete is required to pay Tina $15,000 of alimony each year. Pete earns $50,000 a year. Therefore, Tina must include the $15,000 in her gross income, and Pete is allowed to deduct $15,000 from his gross income. ■

A transfer of property other than cash to a former spouse under a divorce decree or agreement is not a taxable event. The transferor is not entitled to a deduction and does not recognize gain or loss on the transfer. The transferee does not recognize income and has a cost basis equal to the transferor's basis.[39]

[38] §§ 71 and 215.

[39] Section 1041 was added to the Code in 1984 to repeal the rule of *U.S. v. Davis*, 62–2 USTC ¶9509, 9 AFTR 2d 1625, 82 S.Ct. 1190 (USSC, 1962). Under the *Davis* rule, which applied to pre-1985 divorces, a property transfer incident to divorce was a taxable event.

EXAMPLE 31

Paul transfers stock to Rosa this year as part of a divorce settlement. The cost of the stock to Paul is $12,000, and the stock's fair market value at the time of the transfer is $15,000. Rosa later sells the stock for $16,000. Paul is not required to recognize gain from the transfer of the stock to Rosa, and Rosa has a realized *and* recognized gain of $4,000 ($16,000 − $12,000) when she sells the stock. ■

In the case of cash payments, however, it is often difficult to distinguish between support payments (alimony) and property settlements. In 1984, Congress developed objective rules to classify these payments.[40]

DIGGING DEEPER 11

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

Child Support

While alimony is taxable, a taxpayer does *not* report income from the receipt of child support payments made by his or her former spouse. This result occurs because the money is received subject to the duty to use the money for the child's benefit. The payor is not allowed to deduct the child support payments because the payments are made to satisfy the payor's legal obligation to support the child.

In many cases, it is difficult to determine whether an amount received is alimony or child support. If the amount of the payments would be reduced upon the happening of a contingency related to a child (e.g., the child attains age 21 or dies), the amount of the future reduction in the payment is deemed child support.[41]

EXAMPLE 32

A divorce agreement provides that Matt is required to make periodic alimony payments of $500 per month to Grace. However, when Matt and Grace's child reaches age 21, marries, or dies (whichever occurs first), the payments will be reduced to $300 per month. Child support payments are $200 each month, and alimony is $300 each month. ■

PRIZES AND AWARDS

The fair market value of prizes and awards must be included in gross income.[42] Therefore, TV giveaway prizes, magazine publisher prizes, door prizes, and awards from an employer to an employee in recognition of performance are fully taxable to the recipient.

A narrow exception permits a prize or award to be excluded from gross income if *all* of the following requirements are satisfied:

- The prize or award is received in recognition of religious, charitable, scientific, educational, artistic, literary, or civic achievement (e.g., Nobel Prize, Pulitzer Prize, faculty teaching award).
- The recipient was selected without taking any action to enter the contest or proceeding.
- The recipient is not required to render substantial future services as a condition for receiving the prize or award.[43]
- The recipient arranges for the prize or award to be paid *directly* to a qualified governmental unit or nonprofit organization.

A taxpayer can avoid including prizes and awards in gross income by refusing to accept the prize or award.

Another exception is provided to allow exclusion of certain employee achievement awards in the form of tangible personal property (e.g., a gold watch). The awards must be made in recognition of length of service or safety achievement. Generally, the

[40]More complex rules existed for determining the nature of payments under pre-1985 agreements.
[41]§ 71(c)(2).
[42]§ 74.
[43]§ 74(b).

TAX in the NEWS

The Appropriate Age for Social Security Benefits

Stories appear frequently in the media describing how the Social Security system is going to run out of money in coming decades. According to John Shoven and Gopi Shah, economists who published a National Bureau of Economic Research paper, a basic reason for Social Security's problem is "age inflation"—people are living longer. If the Social Security retirement age is not raised to account for longer life expectancies, 20 percent of the population will be eligible for Social Security retirement benefits by 2050.

When Social Security was created in 1935, a 65-year-old could expect to live an additional 12 years. Currently, a 65-year-old can expect to live an additional 20 years. That amounts to a lot of additional benefits to be paid out by the Social Security Administration.

Source: Adapted from Brian Blackstone, "Report Urges Raising the Social Security Age," *Wall Street Journal*, August 20, 2008, p. D2.

ceiling on the excludible amount for an employee is $400 per taxable year. However, if the award is a *qualified plan award*, the ceiling on the exclusion is $1,600 per taxable year.[44]

UNEMPLOYMENT COMPENSATION

The unemployment compensation program is sponsored and operated by the states and Federal government to provide a source of income for people who have been employed and are temporarily out of work. In a series of rulings over a period of 40 years, the IRS exempted unemployment benefits from tax. These payments were considered social benefit programs for the promotion of the general welfare. After experiencing dissatisfaction with the IRS's treatment of unemployment compensation, Congress amended the Code to provide that the benefits are taxable.[45]

In the American Recovery and Reinvestment Tax Act (ARRTA) of 2009, Congress provided that the first $2,400 of unemployment compensation is excluded from gross income. Although this relief from taxation is limited to 2009, an extension can be expected as long as the current economic difficulties continue.

SOCIAL SECURITY BENEFITS

If a taxpayer's income exceeds a specified base amount, as much as 50 or 85 percent of Social Security retirement benefits must be included in gross income. The taxable amount of benefits is determined through the application of one of two complex formulas described in § 86.

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

12 DIGGING DEEPER

16.9 Specific Exclusions Applicable to Individuals

GIFTS AND INHERITANCES

Beginning with the Income Tax Act of 1913 and continuing to the present, Congress has allowed the recipient of a **gift** to exclude the value of the property from gross income. The exclusion applies to gifts made during the life of the donor (*inter vivos* gifts)

[44] §§ 74(c) and 274(j).
[45] § 85.

and transfers that take effect upon the death of the donor (bequests and inheritances).[46] However, the recipient of a gift of income-producing property is subject to tax on the income subsequently earned from the property. Also, as discussed in Chapter 1, the donor or the decedent's estate may be subject to gift or estate taxes on such transfers.

In numerous cases, gifts are made in a business setting. For example, a salesperson gives a purchasing agent free samples; an employee receives cash from his or her employer on retirement; a corporation makes payments to employees who were victims of a natural disaster; a corporation makes a cash payment to a deceased employee's spouse. In these and similar instances, it is frequently unclear whether the payment was a gift or represents compensation for past, present, or future services.

The courts have defined a gift as "a voluntary transfer of property by one to another without adequate consideration or compensation therefrom."[47] If the payment is intended to be for services rendered, it is not a gift, even though the payment is made without legal or moral obligation and the payor receives no economic benefit from the transfer. To qualify as a gift, the payment must be made "out of affection, respect, admiration, charity or like impulses."[48] Thus, the cases on this issue have been decided on the basis of the donor's intent.[49]

In the case of cash or other property received by an employee from his or her employer, Congress has eliminated any ambiguity. Transfers from an employer to an employee cannot be excluded as a gift.[50]



In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

SCHOLARSHIPS

General Information

Payments or benefits received by a student at an educational institution may be (1) compensation for services, (2) a gift, or (3) a scholarship. If the payments or benefits are received as compensation for services (past or present), the fact that the recipient is a student generally does not render the amounts received nontaxable.[51]

EXAMPLE 36

State University waives tuition for all graduate teaching assistants. The tuition waived is intended as compensation for services and is therefore included in the graduate assistant's gross income. ■

The **scholarship** rules are intended to provide exclusion treatment for education-related benefits that cannot qualify as gifts but are not compensation for services. According to the Regulations, "a scholarship is an amount paid or allowed to, or for the benefit of, an individual to aid such individual in the pursuit of study or research."[52] The recipient must be a candidate for a degree at an educational institution.[53]

EXAMPLE 37

Terry enters a contest sponsored by a local newspaper. Each contestant is required to submit an essay on local environmental issues. The prize is one year's tuition at State University. Terry wins the contest. The newspaper has a legal obligation to Terry (as the contest winner). Thus, the benefits are not a gift. However, since the tuition payment aids Terry in pursuing her studies and is not compensation for services, the payment is a scholarship. ■

[46] § 102.

[47] *Estate of D. R. Daly*, 3 B.T.A. 1042 (1926).

[48] *Robertson v. U.S.*, 52–1 USTC ¶9343, 41 AFTR 1053, 72 S.Ct. 994 (USSC, 1952).

[49] See, for example, *Comm. v. Duberstein*, 60–2 USTC ¶9515, 5 AFTR 2d 1626, 80 S.Ct. 1190 (USSC, 1960).

[50] § 102(c).

[51] Reg. § 1.117–2(a). See *C. P. Bhalla*, 35 TCM 13 (1960), for a discussion of the distinction between a scholarship and compensation. See also *Bingler v. Johnson*, 69–1 USTC ¶9348, 23 AFTR 2d 1212, 89 S.Ct. 1439 (USSC, 1969). For potential exclusion treatment, see the discussion of qualified tuition reductions in Chapter 17.

[52] Prop.Reg. § 1.117–6(c)(3)(i).

[53] § 117(a).

A scholarship recipient may exclude from gross income the amount used for tuition and related expenses (fees, books, supplies, and equipment required for courses), provided the conditions of the grant do not require that the funds be used for other purposes.[54] Amounts received for room and board are taxable and are treated as earned income for purposes of calculating the standard deduction for a taxpayer who is another taxpayer's dependent.[55]

EXAMPLE 38

Kelly receives a scholarship of $9,500 from State University to be used to pursue a bachelor's degree. She spends $4,000 on tuition, $3,000 on books and supplies, and $2,500 for room and board. Kelly may exclude $7,000 ($4,000 + $3,000) from gross income. The $2,500 spent for room and board is includible in Kelly's gross income.

The scholarship is Kelly's only source of income. Her parents provide more than 50% of Kelly's support and claim her as a dependent. Kelly's standard deduction of $2,800 ($2,500 + $300) exceeds her $2,500 gross income. Thus, she has no taxable income. ■

Timing Issues

Frequently, the scholarship recipient is a cash basis taxpayer who receives the money in one tax year but pays the educational expenses in a subsequent year. The amount eligible for exclusion may not be known at the time the money is received. In that case, the transaction is held open until the educational expenses are paid.[56]

EXAMPLE 39

In August 2010, Sanjay received $10,000 as a scholarship for the academic year 2010–2011. Sanjay's expenditures for tuition, books, and supplies were as follows:

August–December 2010	$3,000
January–May 2011	4,500
	$7,500

Sanjay's gross income for 2011 includes $2,500 ($10,000 − $7,500) that is not excludible as a scholarship. None of the scholarship is included in his gross income in 2010. ■

Disguised Compensation

Some employers make scholarships available solely to the children of key employees. The tax objective of these plans is to provide a nontaxable fringe benefit to the executives by making the payment to the child in the form of an excludible scholarship. However, the IRS has ruled that the payments are generally includible by the parent-employee as compensation for services.[57]

DAMAGES

A person who suffers harm caused by another is often entitled to **compensatory damages**. The tax consequences of the receipt of damages depend on the type of harm the taxpayer has experienced. The taxpayer may seek recovery for (1) a loss of income, (2) expenses incurred, (3) property destroyed, or (4) personal injury.

Generally, reimbursement for a loss of income is taxed in the same manner as the income replaced (see the exception under Personal Injury below). Damages that are a recovery of expenses previously deducted by the taxpayer are generally taxable under the tax benefit rule (refer to Chapter 4).

A payment for damaged or destroyed property is treated as an amount received in a sale or exchange of the property. Thus, the taxpayer has a realized gain if the damage payments received exceed the property's basis. Damages for personal injuries receive special treatment under the Code.

[54] § 117(b).
[55] Prop.Reg. § 1.117–6(h).
[56] Prop.Reg. § 1.117–6(b)(2).
[57] Rev.Rul. 75–448, 1975–2 C.B. 55 and *Richard T. Armantrout*, 67 T.C. 996 (1977).

Personal Injury

The legal theory of personal injury damages is that the amount received is intended "to make the plaintiff [the injured party] whole as before the injury."[58] It follows that if the damage payments received were subject to tax, the after-tax amount received would be less than the actual damages incurred and the injured party would not be "whole as before the injury."

With regard to personal injury damages, a distinction is made between compensatory damages and **punitive damages**. Under specified circumstances, compensatory damages may be excluded from gross income. Under no circumstances may punitive damages be excluded from gross income.

Compensatory damages are intended to compensate the taxpayer for the damages incurred. Only those compensatory damages received on account of *physical personal injury or sickness* can be excluded from gross income.[59] Such exclusion treatment includes amounts received for loss of income associated with the physical personal injury or physical sickness. Compensatory damages awarded on account of emotional distress are not received on account of physical injury or sickness and thus cannot be excluded from gross income (except to the extent of any amount received for medical care). Likewise, any amounts received for age discrimination or injury to one's reputation cannot be excluded.

Punitive damages are amounts the party that caused the harm must pay to the victim as punishment for outrageous conduct. Punitive damages are not intended to compensate the victim, but rather to punish the party that caused the harm. Thus, it follows that amounts received as punitive damages may actually place the victim in a better economic position than before the harm was experienced. Logically, punitive damages are thus included in gross income.

EXAMPLE 40

Tom, a television announcer, was dissatisfied with the manner in which Ron, an attorney, was defending the television station in a libel case. Tom stated on the air that Ron was botching the case. Ron sued Tom for slander, claiming damages for loss of income from clients and potential clients who heard Tom's statement. Ron's claim is for damages to his business reputation, and the amounts received are taxable.

Ron collected on the suit against Tom and was on his way to a party to celebrate his victory when a negligent driver, Norm, drove a truck into Ron's automobile, injuring Ron. Ron filed suit for the physical personal injuries and claimed as damages the loss of income for the period he was unable to work as a result of the injuries. Ron also collected punitive damages that were awarded because of Norm's extremely negligent behavior. Ron's wife also collected damages for the emotional distress she experienced as a result of the accident. Ron may exclude the amounts he received for damages, except the punitive damages. Ron's wife must include the amounts she received for damages in gross income because the amounts were not received because of physical personal injuries or sickness. ■

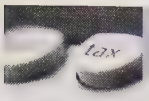
WORKERS' COMPENSATION

State workers' compensation laws require the employer to pay fixed amounts for specific job-related injuries. The state laws were enacted so that the employee will not have to go through the ordeal of a lawsuit (and possibly not collect damages because of some defense available to the employer) to recover the damages. Although the payments are intended, in part, to compensate for a loss of future income, Congress has specifically exempted workers' compensation benefits from inclusion in gross income.[60]

[58] *C. A. Hawkins*, 6 B.T.A. 1023 (1928).

[59] § 104(a)(2).

[60] § 104(a)(1).



CONCEPT SUMMARY 16.2

Taxation of Damages

Type of Claim	Taxation of Award or Settlement
Breach of contract (generally loss of income)	Taxable.
Property damages	Recovery of cost; gain to the extent of the excess over basis. A loss is deductible for business property and investment property to the extent of basis over the amount realized. A loss may be deductible for personal-use property (see discussion of casualty losses in Chapter 6).
Personal injury	
Physical	All compensatory amounts are excluded unless previously deducted (e.g., medical expenses). Amounts received as punitive damages are included in gross income.
Nonphysical	Compensatory damages and punitive damages are included in gross income.

ACCIDENT AND HEALTH INSURANCE BENEFITS

The income tax treatment of **accident and health insurance benefits** depends on whether the policy providing the benefits was purchased by the taxpayer or the taxpayer's employer. Benefits collected under an accident and health insurance policy purchased by the taxpayer are excludible. In this case, benefits collected under the taxpayer's insurance policy are excluded even though the payments are a substitute for income.[61]

EXAMPLE 43

Bonnie purchases a medical and disability insurance policy. The insurance company pays Bonnie $1,000 per week to replace wages she loses while in the hospital. Although the payments serve as a substitute for income, the amounts received are tax-exempt benefits collected under Bonnie's insurance policy. ■

EXAMPLE 44

Joe's injury results in a partial paralysis of his left foot. He receives $20,000 for the injury from his accident insurance company under a policy he had purchased. The $20,000 accident insurance proceeds are tax-exempt. ■

A different set of rules applies if the accident and health insurance protection was purchased by the individual's employer, as discussed in Chapter 17.

EDUCATIONAL SAVINGS BONDS

The cost of a college education has risen dramatically during the past 15 years. According to U.S. Department of Education estimates, the cost of attending a publicly supported university for four years now commonly exceeds $60,000. For a private university, the cost often exceeds $200,000. Consequently, Congress has attempted to assist low- to middle-income parents in saving for their children's college education.

The assistance is in the form of an interest income exclusion on **educational savings bonds**.[62] The interest on U.S. government Series EE savings bonds may be

[61] § 104(a)(3).

[62] § 135.

excluded from gross income if the bond proceeds are used to pay qualified higher education expenses. The exclusion applies only if both of the following requirements are satisfied:

- The savings bonds are issued after December 31, 1989.
- The savings bonds are issued to an individual who is at least 24 years old at the time of issuance.

The redemption proceeds must be used to pay qualified higher education expenses. Qualified higher education expenses consist of tuition and fees paid to an eligible educational institution for the taxpayer, spouse, or dependent. In calculating qualified higher education expenses, the tuition and fees paid are reduced by excludible scholarships and veterans' benefits received. If the redemption proceeds (both principal and interest) exceed the qualified higher education expenses, only a pro rata portion of the interest will qualify for exclusion treatment.

EXAMPLE 43

Tracy's redemption proceeds from qualified savings bonds during the taxable year are $6,000 (principal of $4,000 and interest of $2,000). Tracy's qualified higher education expenses are $5,000. Since the redemption proceeds exceed the qualified higher education expenses, only $1,667 [($5,000/$6,000) × $2,000] of the interest is excludible. ■

The exclusion is limited by the application of the wherewithal to pay concept. That is, once the *modified AGI (MAGI)* exceeds a threshold amount, the phaseout of the exclusion begins. The threshold amounts are adjusted for inflation each year. For 2010, the phaseout begins at $70,100 ($105,100 on a joint return).[63] The phaseout is completed when MAGI exceeds the threshold amount by more than $15,000 ($30,000 on a joint return). The otherwise excludible interest is reduced by the amount calculated as follows:

$$\frac{\text{MAGI} - \$70{,}100}{\$15{,}000} \times \begin{matrix}\text{Excludible interest} \\ \text{before phaseout}\end{matrix} = \begin{matrix}\text{Reduction in} \\ \text{excludible interest}\end{matrix}$$

On a joint return, $105,100 is substituted for $70,100 (in 2010), and $30,000 is substituted for $15,000.

EXAMPLE 44

Assume the same facts as in Example 43, except that Tracy's MAGI for 2010 is $80,000. The phaseout results in Tracy's interest exclusion being reduced by $1,100 {[($80,000 − $70,100)/$15,000] × $1,667}. Therefore, Tracy's exclusion is $567 ($1,667 − $1,100). ■

16.10 Itemized Deductions

LO.9

Determine an individual's allowable itemized deductions.

Taxpayers are allowed to deduct specified expenditures as itemized deductions. Itemized deductions, which are reported on Schedule A, can be classified as follows:

- Expenses that are purely *personal* in nature.
- Expenses incurred by *employees* in connection with their employment activities.
- Expenses related to (1) the *production or collection of income* and (2) the *management of property* held for the production of income.[64]

Expenses in the third category, sometimes referred to as *nonbusiness expenses*, differ from trade or business expenses (discussed previously). Trade or business expenses, which are deductions *for* AGI, must be incurred in connection with a trade or business. Nonbusiness expenses, on the other hand, are expenses incurred in

[63] The indexed amounts for 2009 were $69,950 and $104,900.

[64] Section 212 allows itemized deductions for these types of activities. However, expenses related to the production of *rental or royalty income* are deductions *for* AGI, not itemized deductions, under § 62(a)(4).

EXHIBIT 16.3 Partial List of Itemized Deductions

Personal Expenditures
Medical expenses (in excess of 7.5% of AGI)
State and local income taxes or sales taxes
Real estate taxes
Personal property taxes
Interest on home mortgage
Charitable contributions (limited to a maximum of 50% of AGI)
Casualty and theft losses (in excess of 10% of AGI)
Tax return preparation fee (in excess of 2% of AGI)

Expenditures Related to Employment (in Excess of 2% of AGI)
Union dues
Professional dues and subscriptions
Certain educational expenses
Unreimbursed employee business expenses

Expenditures Related to Income-Producing Activities
Investment interest (to the extent of investment income)
Investment counsel fees (in excess of 2% of AGI)
Other investment expenses (in excess of 2% of AGI)

connection with an income-producing activity that does not qualify as a trade or business. If the nonbusiness expense is incurred in connection with rent or royalty property, it is classified as a deduction *for* AGI. Otherwise, it is classified as a deduction *from* AGI. Itemized deductions include, but are not limited to, the expenses listed in Exhibit 16.3.

Allowable itemized deductions are deductible *from* AGI in arriving at taxable income if the taxpayer elects to itemize. The election to itemize is appropriate when total itemized deductions exceed the standard deduction based on the taxpayer's filing status. The more important itemized deductions are discussed below.

MEDICAL EXPENSES

Medical Expenses Defined

Medical expenses paid for the care of the taxpayer, spouse, and dependents are allowed as an itemized deduction to the extent the expenses are not reimbursed. The medical expense deduction is limited to the amount by which such expenses exceed 7.5 percent of the taxpayer's AGI.

EXAMPLE 16.5

During the year, Iris had medical expenses of $4,800, of which $1,000 was reimbursed by her insurance company. If her AGI for the year is $40,000, the itemized deduction for medical expenses is limited to $800 [($4,800 − $1,000) − (7.5% × $40,000)]. ■

The term *medical care* includes expenditures incurred for the "diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body."[65] Medical expense also includes premiums paid for health care insurance, prescribed drugs and insulin, and lodging while away from home for the purpose of obtaining medical care. Examples of deductible and nondeductible medical expenses appear in Exhibit 16.4.

[65] § 213(d).

EXHIBIT 16.4 Examples of Deductible and Nondeductible Medical Expenses

Deductible	Nondeductible
Medical (including dental, mental, and hospital) care	Funeral, burial, or cremation expenses
Prescription drugs	Nonprescription drugs (except insulin)
Special equipment	Bottled water
Wheelchairs	Diaper service, maternity clothes
Crutches	Programs for the general improvement of health
Artificial limbs	Weight reduction
Eyeglasses (including contact lenses)	Health spas
Hearing aids	Social activities (e.g., dancing and swimming lessons)
Transportation for medical care	Unnecessary cosmetic surgery
Medical and hospital insurance premiums	
Long-term care insurance premiums (subject to limitations)	
Cost of alcohol and drug rehabilitation	
Certain costs to stop smoking	
Weight reduction programs related to obesity	

Cosmetic Surgery

Amounts paid for unnecessary cosmetic surgery are not deductible medical expenses. However, if cosmetic surgery is deemed necessary, it is deductible as a medical expense. Cosmetic surgery is necessary when it ameliorates (1) a deformity arising from a congenital abnormality, (2) a personal injury, or (3) a disfiguring disease.

Nursing Home Care

The cost of care in a nursing home or home for the aged, including meals and lodging, can be included in deductible medical expenses if the primary reason for being in the home is to get medical care. If the primary reason for being there is personal, any costs for medical or nursing care can be included in deductible medical expenses, but the cost of meals and lodging must be excluded.

Capital Expenditures

The treatment of certain illnesses may require expenditures for equipment, special structures, or modification of the taxpayer's residence. Some examples of capital expenditures for medical purposes are swimming pools if the taxpayer does not have access to a neighborhood pool and air conditioners if they do not become permanent improvements (e.g., window units).[66] Other examples include dust elimination systems,[67] elevators,[68] and vans specially designed for wheelchair-bound taxpayers. These expenditures are medical in nature if they are incurred as a medical necessity upon the advice of a physician, the facility is used primarily by the patient alone, and the expense is reasonable.

Capital expenditures normally are adjustments to basis and are deductible only through depreciation. However, both a capital expenditure for a permanent improvement and expenditures made for the operation or maintenance of the

[66]Reg. § 1.213–1(e)(1)(iii).
[67]Ltr.Rul. 7948029.
[68]*Riach v. Frank*, 62–1 USTC ¶9419, 9 AFTR 2d 1263, 302 F.2d 374 (CA–9, 1962).

TAX in the NEWS

The President and Vice President Itemize

Approximately two-thirds of all individual taxpayers take the standard deduction each year rather than itemize. President Barack H. Obama and Vice President Joseph R. Biden are among the one-third who itemize. Both the President and the Vice President, who file joint returns with their wives, released their 2008 income tax returns to the public in 2009. Their itemized deductions, along with certain other information from their tax returns, are shown at the right.

	President Obama	Vice President Biden
Gross income	$2,736,107	$269,256
Adjusted gross income	$2,656,902	$269,256
Itemized deductions:		
Medical expenses	$ –0–	$ –0–
Taxes	100,116	23,561
Interest	54,323	37,264
Charitable contributions	172,050	1,885
Job expenses and other miscellaneous deductions	–0–	–0–
Total itemized deductions	$ 326,489	$ 62,710

improvement may qualify as medical expenses. If a capital expenditure qualifies as a medical expense, the allowable amount is deductible in the *year incurred.* The allowable amount is the excess of the cost of the capital expenditure over the increase in the value of the related property.

Medical Expenses for Spouse and Dependents

In computing the medical expense deduction, a taxpayer may include medical expenses for a spouse and for a person who was a dependent at the time the expenses were paid or incurred. Of the requirements that normally apply in determining dependency status, neither the gross income nor the joint return test applies in determining dependency status for medical expense deduction purposes.

Transportation and Lodging

Payments for transportation to and from a hospital or other medical facility for medical care are deductible as medical expenses (subject to the 7.5 percent floor). Transportation expenses for medical care include bus, taxi, train, or plane fare, charges for ambulance service, and out-of-pocket expenses for the use of an automobile. A mileage allowance of 16.5 cents per mile[69] for 2010 may be used instead of actual out-of-pocket automobile expenses. Whether the taxpayer chooses to claim out-of-pocket automobile expenses or the 16.5 cents per mile automatic mileage option, related parking fees and tolls can also be deducted. The cost of meals while en route to obtain medical care is not deductible.

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

14 DIGGING DEEPER

Health Savings Accounts

Qualifying individuals may make deductible contributions to a **Health Savings Account (HSA)**. An HSA is a qualified trust or custodial account administered by a qualified HSA trustee, which can be a bank, insurance company, or other IRS-approved trustee. The HSA funds are used to pay for the individual's medical expenses in excess of the deductible amount under a high-deductible policy.[70]

[69]This amount is adjusted periodically. The amount was 24 cents per mile for 2009.

[70]§ 223.

A taxpayer can use an HSA in conjunction with a high-deductible medical insurance policy to help reduce the overall cost of medical coverage. The high-deductible policy provides coverage for extraordinary medical expenses (in excess of the deductible), and expenses not covered by the policy can be paid with funds withdrawn tax-free from the HSA.

EXAMPLE 46

Sanchez, who is married and has three dependent children, carries a high-deductible medical insurance policy with a deductible of $4,400. He establishes an HSA and contributes the maximum allowable amount to the HSA in 2010. During 2010, the Sanchez family incurs medical expenses of $7,000. The high-deductible policy covers $2,600 of the expenses ($7,000 expenses − $4,400 deductible). Sanchez may withdraw $4,400 from the HSA to pay the medical expenses not covered by the high-deductible policy. ■

High-Deductible Plans High-deductible policies are less expensive than low-deductible policies, so taxpayers with low medical costs can benefit from the lower premiums and use funds from the HSA to pay costs not covered by the high-deductible policy. A plan must meet two requirements to qualify as a high-deductible plan.[71]

1. The annual deductible in 2010 is not less than $1,200 for self-only coverage ($2,400 for family coverage).
2. The annual limit in 2010 on total out-of-pocket costs (excluding the premiums) under the plan does not exceed $5,950 for self-only coverage ($11,900 for family coverage).

Tax Treatment of HSA Contributions and Distributions To establish an HSA, a taxpayer contributes funds to a tax-exempt trust.[72] As illustrated in the preceding example, funds can be withdrawn from an HSA to pay medical expenses that are not covered by the high-deductible policy. The following general tax rules apply to HSAs:

1. Contributions made by the taxpayer to an HSA are deductible from gross income to arrive at AGI (deduction *for* AGI). Thus, the taxpayer does not need to itemize in order to take the deduction.
2. Earnings on HSAs are not subject to taxation unless distributed, in which case taxability depends on the way the funds are used.[73]
   - Distributions from HSAs are excluded from gross income if they are used to pay for medical expenses not covered by the high-deductible policy.
   - Distributions that are not used to pay for medical expenses are included in gross income and are subject to an additional 10 percent penalty if made before age 65, death, or disability. Such distributions made by reason of death or disability and distributions made after the HSA beneficiary becomes eligible for Medicare are taxed but not penalized.

HSAs have at least two other attractive features. First, an HSA is portable. Taxpayers who switch jobs can take their HSAs with them. Second, more people than ever before can qualify to set up an HSA. Generally, anyone under age 65 who has a high-deductible plan and is not covered by another policy that is not a high-deductible plan can establish an HSA.

Deductible Amount The annual deduction for contributions to an HSA is limited to the sum of the monthly limitations. The monthly limitation is calculated for each month that the individual is an eligible individual. The monthly deduction is not allowed after the individual becomes eligible for Medicare coverage.

The amount of the monthly limitation for an individual who has self-only coverage in 2010 is one-twelfth of $3,050, while the monthly limitation for an individual who has family coverage in 2010 is one-twelfth of $6,150. These amounts are subject

[71] § 223(c)(2).
[72] § 223(d).
[73] § 223(f).

to annual cost-of-living adjustments.[74] An eligible taxpayer who has attained the age of 55 by the end of the tax year may make an additional annual contribution in 2010 of up to $1,000.

Liu, who is married and self-employed, carries a high-deductible medical insurance policy with family coverage and an annual deductible of $4,000. In addition, he has established an HSA. Liu's maximum annual contribution to the HSA in 2010 is $6,150. ■

During 2010, Adam, who is self-employed, made 12 monthly payments of $875 for an HSA contract that provides medical insurance coverage with a $3,600 deductible. The plan covers Adam, his wife, and their two children. Of the $875 monthly fee, $400 was for the high-deductible policy, and $475 was deposited into an HSA. The deductible monthly contribution to the HSA is calculated as follows:

Maximum annual deduction for family coverage	$6,150.00
Monthly limitation (1/12 of $6,150)	512.50

Because Adam is self-employed, he can deduct $4,800 of the amount paid for the high-deductible policy ($400 per month × 12 months) as a deduction *for* AGI (refer to Chapter 17). In addition, he can deduct the $5,700 ($475 × 12) paid to the HSA as a deduction *for* AGI. Note that the $5,700 HSA deduction does not exceed the $6,150 ceiling. ■

TAXES

A deduction is allowed for certain state and local taxes paid or accrued by a taxpayer.[75] The deduction was created to relieve the burden of multiple taxes upon the same source of revenue.

Deductible taxes must be distinguished from nondeductible fees. Fees for special privileges or services are not deductible as itemized deductions if personal in nature. Examples include fees for dog licenses, automobile inspections, automobile titles and registration, hunting and fishing licenses, bridge and highway tolls, drivers' licenses, parking meter deposits, and postage. These items, however, could be deductible if incurred as a business expense or for the production of income (refer to Chapter 5). Deductible and nondeductible taxes for purposes of computing itemized deductions are summarized in Exhibit 16.5.

Personal Property Taxes

Deductible personal property taxes must be *ad valorem* (assessed in relation to the value of the property). Therefore, a motor vehicle tax based on weight, model, year, or horsepower is not an ad valorem tax. In contrast, a motor vehicle tax based on the value of the car is deductible.

A state imposes a motor vehicle registration tax on 4% of the value of the vehicle plus 40 cents per hundredweight. Belle, a resident of the state, owns a car having a value of $4,000 and weighing 3,000 pounds. Belle pays an annual registration fee of $172. Of this amount, $160 (4% of $4,000) is deductible as a personal property tax. The remaining $12, based on the weight of the car, is not deductible. ■

Real Estate Taxes

Real estate taxes of individuals are generally deductible. Taxes on personal-use property and investment property are deductible as itemized deductions. Taxes on business property are deductible as business expenses. Real property taxes on

[74] § 223(b)(2). The annual limits were $3,000 and $5,950 in 2009. Section 223(b)(8) allows a taxpayer who is an eligible member of a high-deductible plan as of the first day of December (for a calendar year taxpayer) to be *treated* as an eligible member of the plan for the entire year. Therefore, for example, if a calendar year taxpayer enrolls in an HSA by December 2010, the limit on the contribution is $3,050 (or $6,150 in the event of family coverage) and not the sum of the monthly limits.

[75] Most deductible taxes are listed in § 164, while the nondeductible items are included in § 275.

EXHIBIT 16.5 Deductible and Nondeductible Taxes

Deductible	Nondeductible
State, local, and foreign real property taxes	Federal income taxes
State and local personal property taxes	FICA taxes imposed on employees
State and local income taxes *or* sales/use taxes*	Employer FICA taxes paid on domestic household workers
State and local sales taxes on a qualified motor vehicle**	Estate, inheritance, and gift taxes
Foreign income taxes	Federal, state, and local excise taxes (e.g., gasoline, tobacco, spirits)
	Taxes on real property to the extent such taxes are to be apportioned and treated as imposed on another taxpayer
	Special assessments for streets, sidewalks, curbing, and other similar improvements

* Currently, the sales/use tax alternative is available through 2009.
** Currently available for purchases on or after February 17, 2009, and before January 1, 2010.

property that is sold during the year must be allocated between the buyer and the seller (refer to Chapter 5).

State and Local Income Taxes and Sales Taxes

The position of the IRS is that state and local *income* taxes imposed upon an individual are deductible only as itemized deductions, even if the taxpayer's sole source of income is from a business, rents, or royalties.

Cash basis taxpayers are entitled to deduct state income taxes withheld by the employer in the year the taxes are withheld. In addition, estimated state income tax payments are deductible in the year the payment is made by cash basis taxpayers even if the payments relate to a prior or subsequent year.[76] If the taxpayer overpays state income taxes because of excessive withholdings or estimated tax payments, the refund received is included in gross income of the following year to the extent that the deduction reduced the taxable income in the prior year.

EXAMPLE 40

Leona, a cash basis, unmarried taxpayer, had $800 of state income tax withheld during 2010. Additionally in 2010, Leona paid $100 that was due when she filed her 2009 state income tax return in 2010 and made estimated payments of $300 on her 2010 state income tax. When Leona files her 2010 Federal income tax return in April 2011, she elects to itemize deductions, which amount to $7,500, including the $1,200 of state income tax payments and withholdings. The itemized deductions reduce her taxable income.

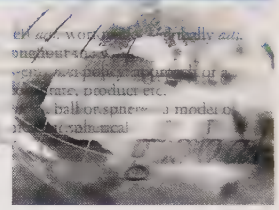
As a result of overpaying her 2010 state income tax, Leona receives a refund of $200 early in 2011. She will include this amount in her 2011 gross income in computing her Federal income tax. It does not matter whether Leona received a check from the state for $200 or applied the $200 toward her 2011 state income tax. ■

Individuals can elect to deduct either their state and local income taxes *or* their sales/use taxes paid as an itemized deduction on Schedule A of Form 1040. The annual election can reflect actual sales/use tax payments *or* an amount from an IRS table. The amount from the table may be increased by sales tax paid on the

[76] Rev.Rul. 71–190, 1971–1 C.B. 70. See also Rev.Rul. 82–208, 1982–2 C.B. 58, where a deduction is not allowed when the taxpayer cannot, in good faith, reasonably determine that there is additional state income tax liability.

Deductibility of Foreign Taxes

GLOBAL *Tax Issues*



Josef, a citizen of the United States who works primarily in New York, also works several months each year in Austria. He owns a residence in Austria and pays income taxes to Austria on the income he earns there. Both the property tax he pays on his Austrian residence and the income tax he pays on his Austrian income are deductible in computing U.S. taxable income. However, if Josef deducts the Austrian income tax, he may not claim the foreign tax credit with respect to this tax (see Chapters 13 and 14).

purchase of motor vehicles, boats, and other specified items. However, if individuals choose to deduct their sales/use taxes paid in 2009 rather than state income taxes, the new standard deduction for sales taxes on autos allowed under the American Recovery and Reinvestment Tax Act of 2009 (see the earlier discussion in this chapter) may not also be taken. Most likely, the sales tax deduction will be elected by those living in states with no individual income tax. At the time of this writing, this deduction alternative is available through 2009.

Tax Planning Strategies Timing the Payment of Deductible Taxes

FRAMEWORK FOCUS: DEDUCTIONS

Strategy: Accelerate Recognition of Deductions to Achieve Tax Deferral.

It is sometimes possible to defer or accelerate the payment of certain deductible taxes, such as state income tax, real property tax, and personal property tax. For instance, the final installment of estimated state income tax is generally due after the end of a given tax year. However, accelerating the payment of the final installment could result in larger itemized deductions for the current year.

INTEREST

For Federal income tax purposes, interest must be divided into five categories: business interest, personal interest, interest on qualified student loans, qualified residence interest, and investment interest. Business interest is fully deductible as an ordinary and necessary expense. Personal (consumer) interest is not deductible. This includes credit card interest, interest on car loans, and any other interest that is not interest on qualified student loans, business interest, qualified residence interest, or investment interest. Interest on qualified student loans, investment interest, and qualified residence (home mortgage) interest are deductible, subject to the limits discussed below.

Interest on Qualified Student Loans

Taxpayers who pay interest on a qualified student loan may be able to deduct the interest as a deduction *for* AGI. The deduction is allowable only to the extent that the proceeds of the loan are used to pay qualified education expenses. The maximum annual deduction is $2,500. However, in 2010 the deduction is phased out for taxpayers with modified AGI (MAGI) between $60,000 and $75,000 ($120,000 and $150,000 on joint returns). The deduction is not available for taxpayers who are claimed as dependents or for married taxpayers filing separately.[77]

[77] § 221. See § 221(b)(2)(C) for the definition of MAGI. For 2009, the MAGI threshold amounts also were $60,000 and $75,000 ($120,000 and $150,000 on joint returns).

In 2010 Curt and Rita, who are married and file a joint return, paid $3,000 interest on a qualified student loan. Their MAGI was $135,000. Their maximum potential deduction for qualified student interest is $2,500, but it must be reduced by $1,250 as a result of the phaseout rules.

$$\$2{,}500 \text{ interest} \times (\$135{,}000 \text{ MAGI} - \$120{,}000 \text{ phaseout floor}) / \$30{,}000 \text{ phaseout range} = \$1{,}250 \text{ reduction}$$

Curt and Rita would be allowed a student loan interest deduction of $1,250 ($2,500 maximum deduction − $1,250 reduction = $1,250 deduction *for* AGI). ■

Investment Interest

Taxpayers frequently borrow funds that they use to acquire investment assets. When the interest expense is large relative to the income from the investments, substantial tax benefits could result. Congress, however, has limited the deductibility of interest on funds borrowed for the purpose of purchasing or continuing to hold investment property. The deduction for **investment interest** expense is limited to **net investment income** for the year.[78]

Investment income is gross income from interest, dividends (see below), annuities, and royalties not derived in the ordinary course of a trade or business. Income from a passive activity and income from a real estate activity in which the taxpayer actively participates are not included in investment income (see Chapter 6).

The following types of income are not included in investment income unless the taxpayer *elects* to do so.

- Net capital gain attributable to the disposition of (1) property producing the types of income just enumerated or (2) property held for investment purposes.
- Qualified dividends that are taxed at the same marginal rate that is applicable to a net capital gain.

A taxpayer may include net capital gains and qualified dividends as investment income by electing to do so. The election is available only if the taxpayer agrees to reduce amounts qualifying for the 15 percent (0 percent for low-income taxpayers) rates that otherwise apply to net capital gain (see Chapter 8) and qualified dividends (refer to Chapter 4) by an equivalent amount.

Terry incurred $13,000 of interest expense related to her investments during the year. Her investment income included $4,000 of interest, $2,000 of qualified dividends, and a $5,000 net capital gain on the sale of investment securities. If Terry does not make the election to include the net capital gain and qualified dividends in investment income, her investment income for purposes of computing the investment income limitation is $4,000 (interest income). If she does make the election, her investment income is $11,000 ($4,000 interest + $2,000 qualified dividends + $5,000 net capital gain). ■

Net investment income is the excess of investment income over investment expenses. Investment expenses are those deductible expenses directly connected with the production of investment income. Investment expenses do not include investment interest expense.



In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

[78] § 163(d).

Qualified Residence Interest

Qualified residence interest is interest paid or accrued during the taxable year on indebtedness (subject to limitations) secured by any property that is a qualified residence of the taxpayer. Qualified residence interest falls into two categories: (1) interest on **acquisition indebtedness** and (2) interest on **home equity loans**. Before discussing each of these categories, however, the term *qualified residence* must be defined.

A qualified residence includes the taxpayer's principal residence and one other residence of the taxpayer or spouse. The principal residence is one that meets the requirement for nonrecognition of gain upon sale under § 121 (see Chapter 7). The one other residence, or second residence, refers to one that is used as a residence if not rented or, if rented, meets the requirements for a personal residence under the rental of vacation home rules. A taxpayer who has more than one second residence can make the selection each year of which one is the qualified second residence. A residence includes, in addition to a house in the ordinary sense, cooperative apartments, condominiums, and mobile homes and boats that have living quarters (sleeping accommodations and toilet and cooking facilities).

Although in most cases interest paid on a home mortgage is fully deductible, there are limitations.[79] Interest paid or accrued during the tax year on aggregate acquisition indebtedness of $1 million or less ($500,000 for married persons filing separate returns) is deductible as qualified residence interest. *Acquisition indebtedness* refers to amounts incurred in acquiring, constructing, or substantially improving a qualified residence of the taxpayer.

Qualified residence interest also includes interest on home equity loans. These loans utilize the personal residence of the taxpayer as security, typically in the form of a second mortgage. Because the funds from home equity loans can be used for personal purposes (e.g., auto purchases, medical expenses), what would otherwise have been nondeductible consumer interest becomes deductible qualified residence interest. However, interest is deductible only on the portion of a home equity loan that does not exceed the lesser of:

- The fair market value of the residence, reduced by the acquisition indebtedness, or
- $100,000 ($50,000 for married persons filing separate returns).

EXAMPLE 34

Larry owns a personal residence with a fair market value of $450,000 and an outstanding first mortgage of $420,000. Therefore, his equity in his home is $30,000 ($450,000 – $420,000). Larry issues a second mortgage on the residence and in return borrows $15,000 to purchase a new family automobile. All interest on the $435,000 of first and second mortgage debt is treated as qualified residence interest. ■

EXAMPLE 35

Leon and Pearl, married taxpayers, took out a mortgage on their home for $200,000 in 1993. In March of the current year, when the home has a fair market value of $400,000 and they owe $195,000 on the mortgage, Leon and Pearl take out a home equity loan for $120,000. They use the funds to purchase an airplane to be used for recreational purposes. On a joint return, Leon and Pearl can deduct all of the interest on the first mortgage since it is acquisition indebtedness. Of the $120,000 home equity loan, only the interest on the first $100,000 is deductible. The interest on the remaining $20,000 is not deductible because it exceeds the statutory ceiling of $100,000. ■

Under current law, mortgage insurance premiums paid by the taxpayer on a qualified residence can be deducted (treated as qualified residence interest). However, the deduction begins to phase out for taxpayers with AGI in excess of $100,000

[79] § 163(h)(3).

($50,000 for married taxpayers filing separately). The deduction is fully phased out when AGI exceeds $109,000 ($54,500 for married taxpayers filing separately).[80]

Interest Paid for Services

Mortgage loan companies commonly charge a fee, often called a loan origination fee, for finding, placing, or processing a mortgage loan. Loan origination fees are typically nondeductible amounts included in the basis of the acquired property. Other fees, sometimes called **points** and expressed as a percentage of the loan amount, are paid to reduce the interest rate charged over the term of the loan. Essentially, the payment of points is a prepayment of interest and is considered compensation to a lender solely for the use or forbearance of money. To be deductible, points must be in the nature of interest and cannot be a form of service charge or payment for specific services.[81]

Points must be capitalized and are amortized and deductible ratably over the life of the loan. A special exception, however, permits the purchaser of a principal residence to deduct qualifying points in the year of payment.[82] The exception also covers points paid to obtain funds for home improvements.

Points paid to refinance an existing home mortgage cannot be immediately expensed, but must be capitalized and amortized as interest expense over the life of the new loan.[83]

EXAMPLE 23

Sandra purchased her residence several years ago, obtaining a 30-year mortgage at an annual interest rate of 9%. In the current year, Sandra refinances the mortgage in order to reduce the interest rate to 6%. To obtain the refinancing, she has to pay points of $2,600. The $2,600 paid comes under the usual rule applicable to points. That is, the $2,600 must be capitalized and amortized over the life of the mortgage. ■

Prepayment Penalty

When a mortgage or loan is paid off in full in a lump sum before its term, the lending institution may require an additional payment of a certain percentage applied to the unpaid amount at the time of prepayment. This is known as a prepayment penalty and is considered to be interest (e.g., personal, qualified residence, investment) in the year paid. The general rules for deductibility of interest also apply to prepayment penalties.

Interest Paid to Related Parties

Nothing prevents the deduction of interest paid to a related party as long as the payment actually took place and the interest meets the requirements for deductibility. However, a special rule applies for related taxpayers when the debtor uses the accrual basis and the related creditor is on the cash basis. If this rule is applicable, interest that has been accrued but not paid at the end of the debtor's tax year is not deductible until payment is made and the income is reportable by the cash basis recipient.

Tax-Exempt Securities

The tax law provides that no deduction is allowed for interest on debt incurred to purchase or carry tax-exempt securities.[84] A major problem for the courts has been to determine what is meant by the words "to purchase or carry." Refer to Chapter 5 for a detailed discussion of these issues.

[80] §§ 163(h)(3)(E)(i) and (ii). This provision is scheduled to expire at the end of 2010.

[81] Rev.Rul. 69–188, 1969–1 C.B. 54.

[82] § 461(g)(2).

[83] Rev.Rul. 87–22, 1987–1 C.B. 146.

[84] § 265(a)(2).

Prepaid Interest

Accrual method reporting is imposed on cash basis taxpayers for interest prepayments that extend beyond the end of the taxable year.[85] Such payments must be allocated to the tax years to which the interest payments relate. These provisions are intended to prevent cash basis taxpayers from *manufacturing* tax deductions before the end of the year by prepaying interest.

Classification of Interest Expense

Whether interest is deductible *for* AGI or as an itemized deduction (*from* AGI) depends on whether the indebtedness has a business, investment, or personal purpose. If the indebtedness is incurred in relation to a business (other than performing services as an employee) or for the production of rent or royalty income, the interest is deductible *for* AGI. If the indebtedness is incurred for personal use, such as qualified residence interest, any deduction allowed is taken *from* AGI and is reported on Schedule A of Form 1040 if the taxpayer elects to itemize. Note, however, that interest on a student loan is deductible *for* AGI. If the taxpayer is an employee who incurs debt in relation to his or her employment, the interest is considered to be personal, or consumer, interest. Business expenses appear on Schedule C of Form 1040, and expenses related to rents or royalties are reported on Schedule E.

CHARITABLE CONTRIBUTIONS

As noted in Chapter 5, § 170 allows individuals to deduct contributions made to qualified domestic organizations. Contributions to qualified charitable organizations serve certain social welfare needs and thus relieve the government of the cost of providing these needed services to the community.

Criteria for a Gift

A **charitable contribution** is defined as a gift made to a qualified organization.[86] The major elements needed to qualify a contribution as a gift are a donative intent, the absence of consideration, and acceptance by the donee. Consequently, the taxpayer has the burden of establishing that the transfer was made from motives of disinterested generosity as established by the courts.[87] This test is quite subjective and has led to problems of interpretation (refer to the discussion of gifts in Chapter 4).

Benefit Received Rule

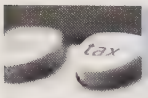
When a donor derives a tangible benefit from a contribution, he or she cannot deduct the value of the benefit.

EXAMPLE 50

Ralph purchases a ticket at $100 for a special performance of the local symphony (a qualified charity). If the price of a ticket to a symphony concert is normally $35, Ralph is allowed only $65 as a charitable contribution. Even if Ralph does not attend the concert, his deduction is limited to $65. However, if he does not accept the ticket from the symphony, he can deduct the full $100. ■

An exception to this benefit rule provides for the deduction of an automatic percentage of the amount paid for the right to purchase athletic tickets from colleges and universities.[88] Under this exception, 80 percent of the amount paid to or for the benefit of the institution qualifies as a charitable contribution deduction.

[85] § 461(g)(1).
[86] § 170(c).
[87] *Comm. v. Duberstein*, 60–2 USTC ¶9515, 5 AFTR 2d 1626, 80 S.Ct. 1190 (USSC, 1960).
[88] § 170(l).



CONCEPT SUMMARY 16.3

Deductibility of Personal, Education, Investment, and Mortgage Interest

Type	Deductible	Comments
Personal (consumer) interest	No	Includes any interest that is not qualified residence interest, interest on qualified student loans, investment interest, or business interest. Examples include interest on car loans and credit card debt.
Qualified student loan interest	Yes	Deduction *for* AGI; subject to limitations.
Investment interest (*not* related to rental or royalty property)	Yes	Itemized deduction; limited to net investment income for the year; disallowed interest can be carried over to future years.
Investment interest (related to rental or royalty property)	Yes	Deduction *for* AGI; limited to net investment income for the year; disallowed interest can be carried over to future years.
Qualified residence interest on acquisition indebtedness	Yes	Deductible as an itemized deduction; limited to indebtedness of $1 million.
Qualified residence interest on home equity indebtedness	Yes	Deductible as an itemized deduction; limited to indebtedness equal to lesser of $100,000 or FMV of residence minus acquisition indebtedness.



In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

Contribution of Services

No deduction is allowed for the value of one's services contributed to a qualified charitable organization. However, unreimbursed expenses related to the services rendered may be deductible. For example, the cost of a uniform (without general utility) that is required to be worn while performing services may be deductible, as are certain out-of-pocket transportation costs incurred for the benefit of the charity. In lieu of these out-of-pocket costs for an automobile, a standard mileage rate of 14 cents per mile is allowed.[89] Deductions are permitted for transportation, reasonable expenses for lodging, and the cost of meals while away from home incurred in performing the donated services. The travel expenses are not deductible if the travel involves a significant element of personal pleasure, recreation, or vacation.[90]

Nondeductible Items

In addition to the benefit received rule and the restrictions placed on the contribution of services, the following items may not be deducted as charitable contributions:

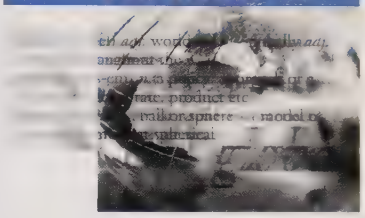
- Dues, fees, or bills paid to country clubs, lodges, fraternal orders, or similar groups.
- Cost of raffle, bingo, or lottery tickets.
- Cost of tuition.
- Value of blood given to a blood bank.
- Donations to homeowners associations.
- Gifts to individuals.
- Rental value of property used by a qualified charity.

[89] § 170(i).

[90] § 170(j).

Choose the Charity Wisely

GLOBAL *Tax Issues*



Ibrahim, a U.S. citizen of Turkish descent, was distressed by the damage caused by a major earthquake in Turkey. He donated $100,000 to the Earthquake Victims' Relief Fund, a Turkish charitable organization that was set up to help victims of the earthquake. Ahmed, also a U.S. citizen of Turkish descent, donated $200,000 to help with the relief effort. However, Ahmed's contribution went to his mosque, which sent the proceeds of a fund drive to the Earthquake Victims' Relief Fund in Turkey. Ibrahim's contribution is not deductible, but Ahmed's is. Why? Contributions to charitable organizations are not deductible unless the organization is a U.S. charity.

Time of Deduction

A charitable contribution generally is deducted in the year the payment is made. This rule applies to both cash and accrual basis individuals. (An interesting exception to this rule arose following the devastating earthquake in Haiti in early 2010. To encourage Americans to assist the victims affected by the earthquake in Haiti, Congress provided that an otherwise qualifying charitable contribution made after January 11, 2010 and before March 1, 2010 could be deducted on a taxpayer's 2009 income tax return rather than the 2010 return.) A contribution is ordinarily deemed to have been made on the date of delivery of the property to the donee. A contribution made by check is considered delivered on the date of mailing. Thus, a check mailed on December 31, 2010, is deductible on the taxpayer's 2010 tax return. If the contribution is charged on a credit card, the date the charge is made determines the year of deduction.

Record-Keeping Requirements

No deduction is allowed for a charitable contribution made to a qualified organization unless the taxpayer gathers (and, in some cases, supplies to the IRS) the appropriate documentation and substantiation. The specific type of documentation required depends on the amount of the contribution and whether the contribution is made in cash or noncash property.[91] In addition, special rules may apply to gifts of certain types of property (e.g., used automobiles) where Congress has noted taxpayer abuse in the past. Further, for certain gifts of noncash property, Form 8283 (Noncash Charitable Contributions) must be attached to the taxpayer's return.

The required substantiation must be obtained before the earlier of (1) the due date (including extensions) of the return for the year the contribution is claimed or (2) the date the return is filed. Failure to comply with the reporting rules may result in disallowance of the charitable contribution deduction. Additionally, significant overvaluation exposes the taxpayer to stringent penalties.

Valuation Requirements

Property donated to a charity is generally valued at fair market value at the time the gift is made. The Code and Regulations give very little guidance on the measurement of the fair market value except to say, "The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts."

Generally, charitable organizations do not attest to the fair market value of the donated property. Nevertheless, the taxpayer must maintain reliable written evidence as to its value.

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft.**

17 DIGGING DEEPER

[91]The specific documentation thresholds and requirements are provided in § 170(f).

Limitations on Charitable Contribution Deduction

The potential charitable contribution deduction is the total of all donations, both money and property, that qualify for the deduction. After this determination is made, the actual amount of the charitable contribution deduction that is allowed for individuals for the tax year is limited as follows:

- If the qualifying contributions for the year total 20 percent or less of AGI, they are fully deductible.
- If the qualifying contributions are more than 20 percent of AGI, the deductible amount may be limited to either 20 percent, 30 percent, or 50 percent of AGI, depending on the type of property given and the type of organization to which the donation is made.
- In any case, the maximum charitable contribution deduction may not exceed 50 percent of AGI for the tax year.

To understand the complex rules for computing the amount of a charitable contribution deduction, it is necessary to understand the distinction between **capital gain property** and **ordinary income property**. These rules, which were discussed in Chapter 5, are summarized in Concept Summary 16.4.

In addition, it is necessary to understand when the 50 percent, 30 percent, and 20 percent limitations apply. If a taxpayer's contributions for the year exceed the applicable percentage limitations, the excess contributions may be carried forward and deducted during a five-year carryover period. These topics are discussed in the sections that follow.

Fifty Percent Ceiling

Contributions made to public charities may not exceed 50 percent of an individual's AGI for the year. Excess contributions may be carried over to the next five years.[92] The 50 percent ceiling on contributions applies to public charities such as churches, schools, hospitals, and Federal, state, or local governmental units. The 50 percent ceiling also applies to contributions to private operating foundations and certain private nonoperating foundations.

In the remaining discussion of charitable contributions, public charities and private foundations (both operating and nonoperating) that qualify for the 50 percent ceiling will be referred to as 50 percent organizations.

Thirty Percent Ceiling

A 30 percent ceiling applies to contributions of cash and ordinary income property to private nonoperating foundations that are not 50 percent organizations. The 30 percent ceiling also applies to contributions of appreciated capital gain property to 50 percent organizations unless the taxpayer makes a special election (see Example 58 below).

In the event the contributions for any one tax year involve both 50 percent and 30 percent property, the allowable deduction comes first from the 50 percent property.

EXAMPLE 58

During the year, Lisa makes the following donations to her church: cash of $2,000 and unimproved land worth $30,000. Lisa had purchased the land four years ago for $22,000 and held it as an investment. Therefore, it is capital gain property. Lisa's AGI for the year is $60,000. Disregarding percentage limitations, Lisa's potential deduction is $32,000 [$2,000 (cash) + $30,000 (fair market value of land)].

In applying the percentage limitations, however, the current deduction for the land is limited to $18,000 [30% (limitation applicable to capital gain property) × $60,000 (AGI)]. Thus, the total current deduction is $20,000 ($2,000 cash + $18,000 land). Note that the total deduction does not exceed $30,000, which is 50% of Lisa's AGI. ■

[92] § 170(d); Reg. § 1.170A–10.



CONCEPT SUMMARY 16.4

Determining the Deduction for Contributions of Property by Individuals

If the Type of Property Contributed Is:	And the Property Is Contributed to:	The Contribution Is Measured by:	But the Deduction Is Limited to:
Capital gain property	A 50% organization	Fair market value of the property	30% of AGI
Ordinary income property	A 50% organization	The basis of the property*	50% of AGI
Capital gain property (and the property is tangible personal property put to an unrelated use by the donee)	A 50% organization	The basis of the property*	50% of AGI
Capital gain property (and the reduced deduction is elected)	A 50% organization	The basis of the property	50% of AGI
Capital gain property	A private nonoperating foundation that is not a 50% organization	The basis of the property*	The lesser of: 1. 20% of AGI 2. 50% of AGI minus other contributions to 50% organizations
Ordinary income property	A private nonoperating foundation that is not a 50% organization	The basis of the property*	30% of AGI

*If the FMV of the property is less than the adjusted basis (i.e., the property has declined in value instead of appreciating), the FMV is used.

Under a special election, a taxpayer may choose to forgo a deduction of the appreciation on capital gain property. Referred to as the reduced deduction election, this enables the taxpayer to move from the 30 percent limitation to the 50 percent limitation.

EXAMPLE 58

Assume the same facts as in Example 57, except that Lisa makes the reduced deduction election. Now the deduction becomes $24,000 [$2,000 (cash) + $22,000 (basis in land)] because both donations fall under the 50% limitation. Thus, by making the election, Lisa has increased her current charitable contribution deduction by $4,000 [$24,000 − $20,000 (Example 57)]. ■

Although the reduced deduction election appears attractive, it should be considered carefully. The election sacrifices a deduction for the appreciation on capital gain property that might eventually be allowed. Note that in Example 57, the potential deduction was $32,000, yet in Example 58 only $24,000 is allowed. The reason the potential deduction is decreased by $8,000 ($32,000 − $24,000) is that no carryover is allowed for the amount sacrificed by the election.

Twenty Percent Ceiling

A 20 percent ceiling applies to contributions of appreciated capital gain property to private nonoperating foundations that are not 50 percent organizations. Also, recall from Chapter 5 that only the basis of the contributed property is allowed as a deduction.

Contribution Carryovers

Contributions that exceed the percentage limitations for the current year can be carried over for five years. In the carryover process, such contributions do not lose their identity for limitation purposes. Thus, if the contribution originally involved 30 percent property, the carryover will continue to be classified as 30 percent property in the carryover year.

Assume the same facts as in Example 57. Because only $18,000 of the $30,000 value of the land is deducted in the current year, the balance of $12,000 may be carried over to the following year. But the carryover will still be treated as capital gain property and will be subject to the 30%-of-AGI limitation. ■

In applying the percentage limitations, current charitable contributions must be claimed first before any carryovers can be considered. If carryovers involve more than one year, they are utilized in a first-in, first-out order.

MISCELLANEOUS ITEMIZED DEDUCTIONS SUBJECT TO TWO PERCENT FLOOR

In general, no deduction is allowed for personal, living, or family expenses.[93] However, a taxpayer may incur a number of deductible expenditures related to employment. If an employee or outside salesperson incurs unreimbursed business expenses or expenses that are reimbursed under a nonaccountable plan (see Chapter 17), including travel and transportation, the expenses are deductible as **miscellaneous itemized deductions**.[94] Certain other expenses also fall into the special category of miscellaneous itemized deductions. Some are deductible only to the extent they exceed 2 percent of the taxpayer's AGI. These miscellaneous itemized deductions include the following:

- Professional dues to membership organizations.
- Uniforms or other clothing that cannot be used for normal wear.
- Fees incurred for the preparation of one's tax return or fees incurred for tax litigation before the IRS or the courts.
- Job-hunting costs.
- Fee paid for a safe deposit box used to store papers and documents relating to taxable income-producing investments.
- Investment expenses that are deductible under § 212 as discussed previously in this chapter.
- Appraisal fees to determine the amount of a casualty loss or the fair market value of donated property.
- Hobby losses up to the amount of hobby income (see Chapter 17).
- Unreimbursed employee expenses (refer to Chapter 17).

Certain employee business expenses that are reimbursed are not itemized deductions, but are deducted *for* AGI. Employee business expenses are discussed in depth in Chapter 17.

OTHER MISCELLANEOUS DEDUCTIONS

Certain expenses and losses do not fall into any category of itemized deductions already discussed but are nonetheless deductible. The following expenses and losses are deductible on Schedule A as Other Miscellaneous Deductions:

- Gambling losses up to the amount of gambling winnings.
- Impairment-related work expenses of a handicapped person.
- Federal estate tax on income in respect of a decedent.
- Deduction for repayment of amounts under a claim of right if more than $3,000.

Unlike the expenses and losses discussed previously under Miscellaneous Itemized Deductions, the above expenses and losses are not subject to the 2 percent-of-AGI floor.

[93] § 262.

[94] Actors and performing artists who meet certain requirements are not subject to this rule. See § 62(a)(2)(B).

OVERALL LIMITATION ON CERTAIN ITEMIZED DEDUCTIONS

Recall from an earlier discussion in this chapter that certain higher-income taxpayers were subject to a phaseout of personal and dependency exemptions that is no longer in effect as of the beginning of 2010. A similar phaseout provision also formerly applied to certain itemized deductions where a limitation was placed on their full deductibility. That limitation does not apply to individual taxpayers for tax years beginning after 2009, and now taxpayers may *fully* deduct any itemized deductions to which they are entitled.[95] However, many believe that in future years, higher-income taxpayers could again be subject to an overall limitation on the deductibility of itemized deductions as Congress searches for ways to reduce significant Federal budget deficits.

Tax Planning Strategies EFFECTIVE UTILIZATION OF ITEMIZED DEDUCTIONS

FRAMEWORK FOCUS: DEDUCTIONS

Strategy: Maximize Deductible Amounts.

An individual may use the standard deduction in one year and itemize deductions in another year. Therefore, it is frequently possible to obtain maximum benefit by shifting itemized deductions from one year to another. For example, if a taxpayer's itemized deductions and the standard deduction are approximately the same for each year of a two-year period, the taxpayer should use the standard deduction in one year and shift itemized deductions (to the extent permitted by law) to the other year. The individual could, for example, prepay a church pledge for a particular year or avoid paying end-of-the-year medical expenses to shift the deduction to the following year.

16.11 INDIVIDUAL TAX CREDITS

LO.10

Understand the adoption expenses credit, child tax credit, education tax credits, credit for child and dependent care expenses, and earned income credit.

ADOPTION EXPENSES CREDIT

Adoption expenses paid or incurred by a taxpayer may give rise to the **adoption expenses credit.**[96] The provision is intended to assist taxpayers who incur nonrecurring costs directly associated with the adoption process, such as adoption fees, attorney fees, court costs, social service review costs, and transportation costs.

In 2010, up to $12,170 of costs incurred to adopt an eligible child qualify for the credit. An eligible child is one who is:

- under 18 years of age at the time of the adoption, or
- physically or mentally incapable of taking care of himself or herself.

A taxpayer may claim the credit in the year qualifying expenses were paid or incurred if they were paid or incurred during or after the tax year in which the adoption was finalized. For qualifying expenses paid or incurred in a tax year prior to the year when the adoption was finalized, the credit must be claimed in the tax year following the tax year during which the expenses are paid or incurred. A married couple must file a joint return in order to claim the credit.

In late 2009, Sam and Martha pay $4,000 in legal fees, adoption fees, and other expenses directly related to the adoption of an infant daughter, Susan. In 2010, the year in which the adoption becomes final, they pay an additional $9,000. Sam and Martha are eligible for a $12,170 credit in 2010 (for expenses of $13,000, limited by the $12,170 ceiling, paid in 2009 and 2010). ■

[95] § 68. In 2009, before the provision's expiration, the limitation applied to taxpayers whose AGI exceeded $166,800 ($83,400 for married taxpayers filing separately). Section 68(g) provides for its termination for tax years beginning after December 31, 2009.

[96] § 23.

The amount of the credit that is otherwise available is subject to phaseout for taxpayers whose AGI (modified for this purpose) exceeds $182,520 in 2010, and is phased out completely when AGI reaches $222,520. The resulting credit is calculated by reducing the allowable credit (determined without this reduction) by the amount determined using the following formula:

$$\text{Allowable credit} \times \frac{\text{AGI} - \$182{,}520}{\$40{,}000}$$

EXAMPLE 92

Assume the same facts as in the previous example, except that Sam and Martha's AGI is $207,520 in 2010. As a result, their available credit in 2010 is reduced from $12,170 to $4,564 {$12,170 − [$12,170 × ($25,000/$40,000)]}. ■

The credit is nonrefundable and is available to taxpayers only in a year in which this credit and the other nonrefundable credits do not exceed the taxpayer's tax liability. However, any unused adoption expenses credit may be carried over for up to five years, being utilized on a first-in, first-out basis.

CHILD TAX CREDIT

The **child tax credit** provision allows individual taxpayers to take a tax credit based solely on the *number* of their qualifying children. This credit is one of several "family-friendly" provisions that currently are part of our tax law. To be eligible for the credit, the child must be under age 17, a U.S. citizen, and claimed as a dependent on the taxpayer's return.

Maximum Credit and Phaseouts

Under current law, the maximum credit available is $1,000 per child.[97] The available credit is phased out for higher-income taxpayers beginning when AGI reaches $110,000 for joint filers ($55,000 for married taxpayers filing separately) and $75,000 for single taxpayers. The credit is phased out by $50 for each $1,000 (or part thereof) of AGI above the threshold amounts.[98] Since the maximum credit available to taxpayers depends on the number of qualifying children, the income level at which the credit is phased out completely also depends on the number of children qualifying for the credit.[99]

EXAMPLE 93

Juanita and Alberto are married and file a joint tax return claiming their two children, ages six and eight, as dependents. Their AGI is $122,400. Juanita and Alberto's maximum child tax credit is $2,000 ($1,000 × 2 children). Since Juanita and Alberto's AGI is in excess of the $110,000 threshold, the maximum credit must be reduced by $50 for every $1,000 (or part thereof) above the threshold amount {$50 × [($122,400 − $110,000)/$1,000]}. Thus, the credit reduction equals $650 [$50 × 13 (rounded up from 12.4)]. Therefore, Juanita and Alberto's child tax credit is $1,350. ■

CREDIT FOR CHILD AND DEPENDENT CARE EXPENSES

A credit is allowed to taxpayers who incur employment-related expenses for child or dependent care.[100] The **credit for child and dependent care expenses** is a specified percentage of expenses incurred to enable the taxpayer to work or to seek employment. Expenses on which the credit for child and dependent care expenses is based are subject to limitations.

[97] § 24. The maximum credit per child is scheduled to remain at $1,000 through 2010.

[98] AGI is modified for purposes of this calculation. The threshold amounts are *not* indexed for inflation. See §§ 24(a) and (b).

[99] The child tax credit is generally refundable to the extent of 15% of the taxpayer's earned income in excess of an inflation-adjusted amount ($3,000 in 2010). The American Recovery and Reinvestment Tax Act of 2009 reduced this threshold to $3,000 for 2009 and 2010. Prior to ARRTA of 2009, the 2009 threshold was $12,550.

[100] § 21.

Eligibility

To be eligible for the credit, an individual must have either of the following:

- A dependent under age 13.
- A dependent or spouse who is physically or mentally incapacitated and who lives with the taxpayer for more than one-half of the year.

Generally, married taxpayers must file a joint return to obtain the credit.

Eligible Employment-Related Expenses

Eligible expenses include amounts paid for household services and care of a qualifying individual that are incurred to enable the taxpayer to be employed. Child and dependent care expenses include expenses incurred in the home, such as payments for a housekeeper. Out-of-the-home expenses incurred for the care of a dependent under the age of 13 also qualify for the credit. In addition, out-of-the-home expenses incurred for an older dependent or spouse who is physically or mentally incapacitated qualify for the credit if that person regularly spends at least eight hours each day in the taxpayer's household. This makes the credit available to taxpayers who keep handicapped older children and elderly relatives in the home instead of institutionalizing them. Out-of-the-home expenses incurred for services provided by a dependent care center will qualify only if the center complies with all applicable laws and regulations of a state or unit of local government.

Child care payments to a relative are eligible for the credit unless the relative is a child (under age 19) of the taxpayer.

Earned Income Ceiling

Qualifying employment-related expenses are limited to an individual's earned income. For married taxpayers, this limitation applies to the spouse with the lesser amount of earned income. Special rules are provided for taxpayers with nonworking spouses who are disabled or are full-time students. If a nonworking spouse is physically or mentally disabled or is a full-time student, he or she is deemed to have earned income for purposes of this limitation. The deemed amount is $250 per month if there is one qualifying individual in the household or $500 per month if there are two or more qualifying individuals in the household. In the case of a student-spouse, the student's income is deemed to be earned only for the months that the student is enrolled on a full-time basis at an educational institution.[101]

Calculation of the Credit

In general, the credit is equal to a percentage of unreimbursed employment-related expenses up to $3,000 for one qualifying individual and $6,000 for two or more individuals. The credit rate varies between 20 percent and 35 percent, depending on the taxpayer's AGI. The following chart shows the applicable percentage for taxpayers as AGI increases:

Adjusted Gross Income		
Over	But Not Over	Applicable Rate of Credit
$ 0	$15,000	35%
15,000	17,000	34%
17,000	19,000	33%
19,000	21,000	32%
21,000	23,000	31%
23,000	25,000	30%
25,000	27,000	29%

[101] § 21(d).

Adjusted Gross Income		
Over	But Not Over	Applicable Rate of Credit
$27,000	$29,000	28%
29,000	31,000	27%
31,000	33,000	26%
33,000	35,000	25%
35,000	37,000	24%
37,000	39,000	23%
39,000	41,000	22%
41,000	43,000	21%
43,000	No limit	20%

EXAMPLE 33

Nancy, who has two children under age 13, worked full-time while her spouse, Ron, attended college for 10 months during the year. Nancy earned $22,000 and incurred $6,200 of child care expenses. Ron is deemed to be fully employed and to have earned $500 for each of the 10 months (or a total of $5,000). Since Nancy and Ron have AGI of $22,000, they are allowed a credit rate of 31%. Nancy and Ron are limited to $5,000 in qualified child care expenses ($6,000 maximum expenses, limited to Ron's deemed earned income of $5,000). Therefore, they are entitled to a tax credit of $1,550 (31% × $5,000) for the year. ■

EDUCATION TAX CREDITS

Two credits, the **American Opportunity credit** and the **lifetime learning credit**,[102] are available to help qualifying low- and middle-income individuals defray the cost of higher education. The credits are available for qualifying tuition and related expenses incurred by students pursuing undergraduate or graduate degrees or vocational training. Books and other course materials are eligible for the American Opportunity credit (but not the lifetime learning credit).[103] Room and board are ineligible for both credits.

Maximum Credit

The American Opportunity credit permits a maximum credit of $2,500 per year (100 percent of the first $2,000 of tuition expenses plus 25 percent of the next $2,000 of tuition expenses) for the *first four years* of postsecondary education.[104] The lifetime learning credit permits a credit of 20 percent of qualifying expenses (up to $10,000 per year) incurred in a year in which the American Opportunity credit is not claimed with respect to a given student. Generally, the lifetime learning credit is used for individuals who are beyond the first four years of postsecondary education.

Eligible Individuals

Both education credits are available for qualified expenses incurred by a taxpayer, taxpayer's spouse, or taxpayer's dependent. The American Opportunity credit is available per eligible student, while the lifetime learning credit is calculated per taxpayer. To be eligible for the American Opportunity credit, a student must take at least one-half the full-time course load for at least one academic term at a qualifying educational institution. No comparable requirement exists for the lifetime learning

[102] § 25A. The HOPE scholarship credit was modified and renamed the American Opportunity tax credit by the American Recovery and Reinvestment Tax Act of 2009 for the 2009 and 2010 tax years. Without congressional intervention, the HOPE scholarship credit will return in 2011.

[103] § 25A(i)(3).

[104] For years prior to 2009, the qualifying expense base for the HOPE scholarship credit was subject to inflation adjustment. The base was $1,200 in 2008 and $1,100 in 2007.

credit. Therefore, taxpayers who are seeking new job skills or maintaining existing skills through graduate training or continuing education are eligible for the lifetime learning credit. Taxpayers who are married must file a joint return in order to claim either education credit.

Income Limitations and Refundability

Both education credits are subject to income limitations, which differ for 2009 and 2010.[105] In addition, the American Opportunity credit is partially refundable and may be used to offset a taxpayer's alternative minimum tax (AMT) liability (the lifetime learning credit is neither refundable nor an AMT liability offset).

The American Opportunity credit amount is phased out, beginning when the taxpayer's AGI (modified for this purpose) reaches $80,000 ($160,000 for married taxpayers filing jointly).[106] The reduction in 2009 and 2010 is equal to the extent to which AGI exceeds $80,000 ($160,000 for married taxpayers filing jointly) as a percentage of a $10,000 phaseout range ($20,000 for married taxpayers filing jointly). As a result, the credit is completely eliminated when modified AGI reaches $90,000 ($180,000 for married taxpayers filing jointly). For 2009 and 2010, the entire credit allowed may be used to reduce a taxpayer's AMT liability. In addition, 40 percent of the American Opportunity credit is refundable.[107] The lifetime learning credit amount is phased out, beginning when the taxpayer's AGI (modified for this purpose) reaches $50,000 ($100,000 for married taxpayers filing jointly). The reduction in 2010 is equal to the extent to which AGI exceeds $50,000 ($100,000 for married filing jointly) as a percentage of a $10,000 ($20,000 for married filing jointly) phaseout range. The credit is completely eliminated when AGI reaches $60,000 ($120,000 for married filing jointly).

EXAMPLE 64

Dean and Audry are married, file a joint tax return, have modified AGI under $160,000 and have two children, Raymond and Kelsey. During fall 2010, Raymond is beginning his freshman year at State University, and Kelsey is beginning her senior year. During the prior semester, Kelsey completed her junior year. Both Raymond and Kelsey are full-time students and may be claimed as dependents on their parents' tax return. Raymond's qualifying expenses total $4,300 for the fall semester while Kelsey's qualifying expenses total $10,200 for the prior and current semesters. For 2010, Dean and Audry may claim a $2,500 American Opportunity credit [(100% × $2,000) + (25% × $2,000)] for both Raymond's and Kelsey's expenses (in total, a $5,000 American Opportunity credit). ■

EXAMPLE 65

Assume the same facts as in Example 64, except that Dean and Audry's modified AGI for 2010 is $172,000. Dean and Audry are eligible to claim a $2,000 American Opportunity credit for 2010. Their $5,000 available American Opportunity credit must be reduced because their modified AGI exceeds the $160,000 limit for married taxpayers. The percentage reduction is computed as the amount by which modified AGI exceeds the limit, expressed as a percentage of the phaseout range, or [($172,000 − $160,000)/$20,000], resulting in a 60% reduction. Therefore, the maximum available credit for 2010 is $2,000 ($5,000 × 40% allowable portion). ■

Restrictions on Double Tax Benefit

Taxpayers are prohibited from receiving a double tax benefit associated with qualifying educational expenses. Therefore, taxpayers who claim an education credit may not deduct the expenses, nor may they claim the credit for amounts that are otherwise excluded from gross income (e.g., scholarships, employer-paid educational

[105] In 2008 and prior years, the HOPE scholarship and lifetime learning credits were combined and subject to a single modified AGI limitation.

[106] These amounts are not adjusted for inflation under the American Recovery and Reinvestment Tax Act of 2009.

[107] If the credit is claimed for a taxpayer subject to §1(g) (the "kiddie tax"), the credit is not refundable.

assistance). However, a taxpayer may claim an education tax credit and exclude from gross income amounts distributed from a Coverdell Education Savings Account (CESA) as long as the distribution is not used for the same expenses for which the credit is claimed.

EARNED INCOME CREDIT

The **earned income credit**, which has been a part of the law for many years, has been justified as a means of providing tax equity to the working poor. In addition, the credit has been designed to help offset regressive taxes that are a part of our tax system, such as the gasoline tax. Further, the credit is intended to encourage economically disadvantaged individuals to become contributing members of the workforce.[108]

Eligibility Requirements

Eligibility for the credit depends not only on the taxpayer meeting the earned income and AGI thresholds, but also on whether he or she has a qualifying child. The term *qualifying child* generally has the same meaning here as it does for purposes of determining who qualifies as a dependent.

In addition to being available for taxpayers with qualifying children, the earned income credit is also available to certain workers without children. However, this provision is available only to such taxpayers aged 25 through 64 who cannot be claimed as a dependent on another taxpayer's return.

Amount of the Credit

The earned income credit is determined by multiplying a maximum amount of earned income by the appropriate credit percentage. Generally, earned income includes employee compensation and net earnings from self-employment but excludes items such as interest, dividends, pension benefits, nontaxable employee compensation, and alimony. If a taxpayer has children, the credit percentage used in the calculation depends on the number of qualifying children. For 2009 and 2010, the American Recovery and Reinvestment Tax Act of 2009 increases the credit percentage for families with three or more children and increases the phaseout threshold amounts for married taxpayers filing joint returns. Thus, in 2010, the maximum earned income credit for a taxpayer with one qualifying child is $3,050 ($8,970 × 34%), $5,036 ($12,590 × 40%) for a taxpayer with two qualifying children, and $5,666 ($12,590 × 45%) for a taxpayer with three or more qualifying children. However, the maximum earned income credit is phased out completely if the taxpayer's earned income or AGI exceeds certain thresholds. To the extent that the greater of earned income or AGI exceeds $21,460 in 2010 for married taxpayers filing a joint return ($16,450 for other taxpayers), the difference, multiplied by the appropriate phaseout percentage, is subtracted from the maximum earned income credit.

It is not necessary for the taxpayer to actually compute the earned income credit. To simplify the compliance process, the IRS issues an Earned Income Credit Table for the determination of the appropriate amount of the credit. This table and a worksheet are included in the instructions available to individual taxpayers.

Advance Payment

The earned income credit is a form of negative income tax (a refundable credit for taxpayers who do not have a tax liability). An eligible individual may elect to receive advance payments of the earned income credit from his or her employer (rather than receiving the credit from the IRS upon filing the tax return). The amount that can be received in advance is limited to 60 percent of the credit that is available to a taxpayer with only one qualifying child. If this election is made, the taxpayer must

[108] § 32. This credit is subject to indexation.

file a certificate of eligibility (Form W–5) with his or her employer and must file a tax return for the year the income is earned.

MAKING WORK PAY CREDIT

In 2009 and 2010, the American Recovery and Reinvestment Tax Act of 2009 includes a refundable income tax credit of up to $400 ($800 for married taxpayers filing jointly). The **Making Work Pay credit**—calculated at a rate of 6.2 percent of earned income—phases out at a rate of 2 percent of modified adjusted gross income above $75,000 ($150,000 for joint returns). As a result, unmarried taxpayers with modified adjusted gross incomes of more than $95,000 ($400 ÷ 2% = $20,000; $75,000 + $20,000 = $95,000) will not receive the credit (the limit is $190,000 for married taxpayers filing jointly).

Most taxpayers will receive this refundable credit through a reduction of income tax withheld from their paychecks.

REFOCUS ON THE BIG PICTURE

THE TAX IMPLICATIONS OF LIFE!

While wages and salaries are normally taxable, Donna and David should be aware that their employers may have provided them with a number of tax-free fringe benefits. In addition, if Donna and David paid monthly premiums for accident and health care plans or contributed to a flexible spending account, those amounts may reduce their taxable income (these items are discussed more fully in Chapter 17). The good news is that Donna's academic scholarship can be excluded from taxable income along with the $10,000 gift received from Donna's grandmother. However, the $250 of interest earned on the money is taxable.

Donna and David have several deductions *for* adjusted gross income. In addition to the alimony paid by David, $3,000 of the capital loss from the stock sale is deductible *for* AGI, and interest on qualified student loans is deductible *for* AGI.

While state income taxes, personal property taxes, and charitable contributions are deductible *from* AGI, Donna and David should claim the standard deduction for a married couple as it exceeds their itemized deductions.

Donna and David will claim three personal and dependency exemptions—one for each spouse and one for David's son. They will determine their tax liability using the tax table for married couples filing a joint return.

Donna and David may be eligible for one or more tax credits including the child tax credit and an education tax credit related to the tuition paid by Donna. If Stephen has unearned income in excess of certain thresholds, Donna and David should be made aware of the potential "kiddie" tax problem.

What If?

What if Donna and David purchase a house in the current year? What are the likely tax implications of owning a new home? If Donna and David purchase a new home, mortgage interest and property taxes paid on the home are treated as additional itemized deductions. Depending on the amount of these deductions, Donna and David's itemized deductions might then exceed their standard deduction, giving them a larger tax deduction and reducing their tax liability even more. Congress has recently enacted other provisions that benefit new homeowners, so Donna and David should make sure they consult with you again before they make the big purchase.

KEY TERMS

Accident and health insurance benefits, 16–35
Acquisition indebtedness, 16–45
Adoption expenses credit, 16–53
Alimony and separate maintenance payments, 16–29
American Opportunity credit, 16–56
Capital gain property, 16–50
Charitable contribution, 16–47
Child tax credit, 16–54
Compensatory damages, 16–33
Credit for child and dependent care expenses, 16–54
Dependency exemption, 16–12
Earned income credit, 16–58
Educational savings bonds, 16–35
E-file, 16–20
Gift, 16–31
Head of household, 16–22
Health Savings Account (HSA), 16–39
Home equity loans, 16–45
Investment interest, 16–44
Itemized deductions, 16–7
Kiddie tax, 16–27
Lifetime learning credit, 16–56
Making Work Pay credit, 16–59
Marriage penalty, 16–22
Medical expenses, 16–37
Miscellaneous itemized deductions, 16–52
Multiple support agreement, 16–15
Net investment income, 16–44
Ordinary income property, 16–50
Personal exemptions, 16–11
Points, 16–46
Punitive damages, 16–34
Qualified residence interest, 16–45
Qualifying child, 16–12
Qualifying relative, 16–13
Scholarship, 16–32
Standard deduction, 16–7
Surviving spouse, 16–22
Tax Table, 16–24
Unearned income, 16–26

SUGGESTED READINGS

William P. Brown, "Recent Cases Expand Potential for Obtaining Innocent Spouse Relief," *Practical Tax Strategies*, August 2009.

Dennis J. Gaffney, John T. Geekie, and Maureen H. Smith-Gaffney, "Dependency Status for a Child of Divorced or Separated Parents," *The Tax Adviser*, February 2009.

Steve L. Gill and G. E. Whittenburg, "Assorted Tax Benefits May Provide Help for the Unemployed," *Practical Tax Strategies*, July 2009.

Edward J. Schnee and W. Eugene Seago, "Expanding the Reach of the Claim of Right Doctrine," *Business Entities*, January/February 2009.

James P. Trebby, "Reduced Income Can Translate into Larger Tax Deductions and Credits," *Practical Tax Strategies*, March 2009.

PROBLEMS

1. **LO.1, 2, 3, 4** Compute the taxable income for 2010 in each of the following independent situations:
   a. Drew and Meg, ages 40 and 41, are married and file a joint return. In addition to three dependent children, they have AGI of $65,000 and itemized deductions of $12,000.
   b. Sybil, age 40, is single and supports her dependent parents who live with her and also supports her grandparents (mother's parents) who are in a nursing home. She has AGI of $80,000 and itemized deductions of $8,000.
   c. Scott, age 49, is an abandoned spouse. His household includes three unmarried stepsons who qualify as his dependents. He has AGI of $75,000 and itemized deductions of $9,500.
   d. Amelia, age 33, is a surviving spouse and maintains a household for her four dependent children. She has AGI of $58,000 and itemized deductions of $10,200.
   e. Dale, age 42, is divorced but maintains the home in which he and his daughter, Jill, live. Jill is single and qualifies as Dale's dependent. Dale has AGI of $64,000 and itemized deductions of $9,900.

2. **LO.1, 2, 3, 4** Compute the taxable income for 2010 for Curtis on the basis of the following information. His filing status is single.

Salary	$90,000
Interest income from bonds issued by the City of San Diego	3,000
Alimony payments made	3,600
Contribution to traditional IRA	5,000
Gift from grandparents	26,000
Capital loss from stock investment	2,000
Amount lost in football office pool (sports gambling is against the law where Curtis lives)	1,500
Number of potential dependents (two cousins, who live in another state)	2
Age	39

3. **LO.1, 2, 3, 4** Compute the taxable income for 2010 for Mattie on the basis of the following information. Mattie is married but has not seen or heard from her husband since 2008.

Salary	$ 60,000
Interest on bonds issued by AT&T Corporation	3,000
Interest on CD issued by Wells Fargo Bank	2,000
Cash dividend received on Chevron common stock	2,200
Life insurance proceeds paid on death of aunt (Mattie was the designated beneficiary of the policy)	10,000
Inheritance received on death of aunt	200,000
Casey (a cousin) repaid a loan Mattie made to him in 2007 (no interest was provided for)	5,000
Itemized deductions (state income tax, property taxes on residence, interest on home mortgage, charitable contributions)	10,200
Number of dependents (children, ages 17 and 18)	2
Age	40

4. **LO.2** Determine the amount of the standard deduction allowed for 2010 in the following independent situations. In each case, assume the taxpayer is claimed as another person's dependent.
   a. Edward, age 18, has income as follows: $600 interest from a certificate of deposit and $6,000 from repairing cars.
   b. Sarah, age 18, has income as follows: $400 cash dividends from a stock investment and $3,600 from handling a paper route.
   c. Colin, age 16, has income as follows: $900 interest on a bank savings account and $700 for painting a neighbor's fence.
   d. Kara, age 15, has income as follows: $300 cash dividends from a stock investment and $600 from grooming pets.
   e. Kay, age 67 and a widow, has income as follows: $400 from a bank savings account and $3,000 from baby-sitting.

5. **LO.4** Using the legend provided below, classify each statement as to the taxpayer for dependency exemption purposes.

Legend	
QC	= Could be a qualifying child
QR	= Could be a qualifying relative
B	= Could satisfy the definition of *both* a qualifying child *and* a qualifying relative
N	= Could not satisfy the definition of *either* a qualifying child *or* a qualifying relative

   a. Taxpayer's son has gross income of $6,000.
   b. Taxpayer's niece has gross income of $3,000.
   c. Taxpayer's mother lives with him.
   d. Taxpayer's daughter is age 25 and disabled.
   e. Taxpayer's daughter is age 18 but does not live with him.
   f. Taxpayer's cousin lives with her.
   g. Taxpayer's brother does not live with her.
   h. Taxpayer's sister lives with him.

i. Taxpayer's nephew is age 20 and a full-time student.
j. Taxpayer's grandson does not live with her and has gross income of $3,000.

6. **LO.3, 4** For tax year 2010, determine the number of personal and dependency exemptions in each of the following independent situations:
   a. Leo and Amanda (ages 48 and 46) are husband and wife and furnish more than 50% of the support of their two children, Elton (age 18) and Trista (age 24). During the year, Elton earns $4,500 providing transportation for elderly persons with disabilities, and Trista receives a $5,000 scholarship for tuition at the law school she attends.
   b. Audry (age 65) is divorced and lives alone. She maintains another household in which her ex-husband, Clint, and his mother, Olive, live and furnishes more than 50% of their support. Olive is age 82 and blind.
   c. Crystal, age 45, furnishes more than 50% of the support of her married son, Andy (age 18), and his wife, Paige (age 19), who live with her. During the year, Andy earned $8,000 from a part-time job. All parties live in Maryland (a common law state).
   d. Assume the same facts as in (c), except that all parties live in New Mexico (a community property state).

ETHICS AND EQUITY

7. **LO.4** For the six years prior to his death in late 2010, Jesse lived with his daughter, Hannah. Because he had no source of income, Jesse was supported by equal contributions from Hannah and his two sons, Bill and Bob. At Jesse's funeral, his surviving children are amazed to discover that none of them has been claiming Jesse as a dependent. Upon the advice of the director of the funeral home, they decide to divide, among themselves, the dependency exemptions for the past six years. Multiple Forms 2120 are executed, and each of the three children files amended returns for different past years. As Jesse died before the end of the current year, no deduction is planned for 2010.

   Comment on the tax expectations of the parties involved.

CRITICAL THINKING

8. **LO.2, 7** Taylor, age 18, is claimed as a dependent by her parents. For 2010, she has the following income: $4,000 wages from a summer job; $1,900 interest from a money market account; and $1,000 interest from City of Boston bonds.
   a. What is Taylor's taxable income for 2010?
   b. What is Taylor's tax for 2010? (Her parents file a joint return and have taxable income of $120,000 [no dividends or capital gains].)

9. **LO.1, 4, 6** Miles (age 42) is a surviving spouse and provides all of the support of his four minor children who live with him. He also maintains the household in which his parents live and furnished 60% of their support. Besides interest on City of Dallas bonds in the amount of $1,500, Miles's father received $2,400 from a part-time job. Miles has a salary of $80,000, a short-term capital loss of $4,000, a cash prize of $1,000 from a church raffle, and itemized deductions of $9,500. Using the Tax Rate Schedules, compute the 2010 tax liability for Miles.

10. **LO.5** Which of the following taxpayers must file a Federal income tax return for 2010?
    a. Ben, age 19, is a full-time college student. He is claimed as a dependent by his parents. He earned $5,000 in wages during the year.
    b. Anita, age 12, is claimed as a dependent by her parents. She earned interest income of $1,200 during the year.
    c. Earl, age 16, is claimed as a dependent by his parents. He earned wages of $2,700 and interest of $1,100 during the year.
    d. Ellen, age 17, is claimed as a dependent by her parents. She earned interest of $300 during the year. In addition, she earned $550 during the summer operating her own business at the beach, where she painted caricatures of her customers.

DECISION MAKING

11. **LO.9** Each year, the Hundleys normally have itemized deductions of $9,500, including a $3,600 pledge payment to their church. Upon the advice of a friend, they do the following: in early January 2010, they pay their pledge for 2009; during 2010, they pay the pledge for 2010; and in late December 2010, they prepay their pledge for 2011.
    a. Explain what the Hundleys are trying to accomplish.
    b. What will be the tax saving if their marginal tax bracket is 25% for all three years? (Assume the standard deduction amounts for 2010 and 2011 are the same.)

12. **LO.8** Astia and Rafel are in the process of negotiating a divorce agreement. They both worked during the marriage and contributed an equal amount to the marital assets. They own a home with a fair market value of $400,000 (cost of $300,000) that is subject to a mortgage of $250,000. They have lived in the home for 12 years. They also have investment assets with a cost of $160,000 and a fair market value of $410,000. Thus, the net worth of the couple is $560,000 ($400,000 − $250,000 + $410,000). The holding period for the investments is longer than one year. Astia would like to continue to live in the house. Therefore, she has proposed that she receive the residence subject to the mortgage, a net value of $150,000. In addition, she would receive $17,600 each year for the next 10 years, which has a present value (at 6% interest) of $130,000. Rafel would receive the investment assets. If Rafel accepts this plan, he must sell one-half of the investments so that he can purchase a home. Assume that you are counseling Rafel. Explain to Rafel whether the proposed agreement would be "fair" on an after-tax basis. **DECISION MAKING**

13. **LO.8** For each of the following, determine the amount that should be included in gross income:
    a. Don was selected as the most valuable player in the World Series. In recognition of this, he was awarded a sports car worth $75,000 plus $100,000 in cash.
    b. Wanda won the Mrs. America beauty contest. She received various prizes valued at $200,000. None of the $200,000 was for a scholarship or travel expenses.
    c. Jacob was awarded the Nobel Prize in Medicine. He directed the Nobel committee to pay the $1.4 million prize to City University, his alma mater.

14. **LO.8** Linda and Don are married and file a joint return. In 2010, they received $12,000 in Social Security benefits and $35,000 in taxable pension benefits and interest. **CRITICAL THINKING**
    a. Compute the couple's adjusted gross income on a joint return.
    b. Don would like to know whether they should sell for $100,000 (at no gain or loss) a corporate bond that pays 8% in interest each year and use the proceeds to buy a $100,000 nontaxable State of Virginia bond that will pay $6,000 in interest each year. **DECISION MAKING**
    c. If Linda in (a) works part-time and earns $30,000, how much would Linda and Don's adjusted gross income increase?

15. **LO.8** Alejandro was awarded an academic scholarship to State University for the 2010–2011 academic year. He received $5,000 in August and $6,000 in December 2010. Alejandro had enough personal savings to pay all expenses as they came due. Alejandro's expenditures for the relevant period were as follows:

Tuition, August 2010	$3,300
Tuition, December 2010	3,400
Room and board	
August–December 2010	3,000
January–May 2011	2,400
Books and educational supplies	
August–December 2010	1,000
January–May 2011	1,200

Determine the effect on Alejandro's gross income for 2010 and 2011.

16. **LO.8** Leigh sued an overzealous bill collector and received the following settlement:

Damage to her automobile the collector attempted to repossess	$ 1,000
Physical damage to her arm caused by the collector	15,000
Loss of income while her arm was healing	8,000
Punitive damages	50,000

    a. What effect does the settlement have on Leigh's gross income?
    b. Assume Leigh also collected $40,000 of damages for slander to her personal reputation caused by the bill collector misrepresenting the facts to Leigh's employer and other creditors. Is this $40,000 included in Leigh's gross income?

17. **LO.9** Rita Smith is employed as a computer consultant. For calendar year 2010, she had AGI of $200,000 and paid the following medical expenses: **COMMUNICATIONS**

Medical insurance premiums	$ 7,400
Doctor and dentist bills for Larry and Shirley (Rita's parents)	7,700
Doctor and dentist bills for Rita	10,500
Prescription medicines for Rita	1,450
Nonprescription insulin for Rita	550

Larry and Shirley would each qualify as Rita's dependent except that they file a joint return. Rita's medical insurance policy does not cover them. Rita filed a claim for reimbursement of $6,000 of her own expenses with her insurance company in December 2010 and received the reimbursement in January 2011. What is Rita's maximum allowable medical expense deduction for 2010? Prepare a memo for your firm's files where you document your conclusions.

ETHICS AND EQUITY

18. **LO.9** Ron, who lives in Phoenix, has a chronic heart problem. He flies to Rochester, Minnesota, several times each year for checkups and treatment at the Mayo Clinic, which has one of the most highly rated heart treatment programs in the United States. On each trip, he visits his two children, who live in Rochester with his ex-wife. Is Ron justified in deducting the cost of his airline tickets and his lodging in Rochester as a medical expense?

ISSUE ID

19. **LO.8, 9** A local ophthalmologist's advertising campaign included a certificate for free LASIK eye surgery for the lucky winner of a drawing. Ahmad held the winning ticket, which was drawn in December 2009. Ahmad had no vision problems and was uncertain what he should do with the prize. In February 2010, Ahmad's daughter, who lives with his former wife, was diagnosed with a vision problem that could be treated with either prescription glasses or LASIK eye surgery. The divorce decree requires that Ahmad pay for all medical expenses incurred for his daughter. Identify the relevant tax issues for Ahmad.

20. **LO.9** Jung suffers from heart problems and, upon the recommendation of a physician, has an elevator installed in his personal residence. In connection with the elevator, Jung incurs and pays the following amounts during the current year:

Elevator and cost of installation	$15,500
Increase in utility bills due to the elevator	750
Cost of certified appraisal	500

The elevator system has an estimated useful life of 20 years. The appraisal was to determine the value of Jung's residence with and without the system. The appraisal states that the system increased the value of Jung's residence by $2,000. How much of these expenses qualifies for the medical expense deduction in the current year?

21. **LO.9** Daniel is a self-employed, calendar year taxpayer. He reports on the cash basis. Daniel made the following estimated state income tax payments:

Date	Amount
January 15, 2010	$1,200 (4th payment for 2009)
April 15, 2010	1,500 (1st payment for 2010)
June 15, 2010	1,500 (2nd payment for 2010)
September 15, 2010	1,500 (3rd payment for 2010)
January 18, 2011	1,500 (4th payment for 2010)

Daniel had a tax overpayment of $800 on his 2009 state income tax return and, rather than requesting a refund, had the overpayment applied to his 2010 state income taxes. What is the amount of Daniel's state income tax itemized deduction for his 2010 Federal income tax return?

DECISION MAKING

COMMUNICATIONS

22. **LO.9** In 2010, Rachel Tweardy incurs $25,000 of interest expense related to her investments. Her investment income includes $9,000 of interest, $5,000 of qualified dividends, and an $8,000 net capital gain on the sale of securities. Rachel asks you to compute the amount of her deduction for investment interest, taking into consideration any options she might have. In addition, she wants your suggestions as to any tax planning alternatives that are available. Write a letter to her that contains your advice. Rachel lives at 11934 Briarpatch Drive, Midlothian, VA 23113.

23. **LO.9** Helen borrowed $200,000 to acquire a parcel of land to be held for investment purposes. During 2010, she paid interest of $20,000 on the loan. She had AGI of $100,000 for the year. Other items related to Helen's investments include the following: CRITICAL THINKING

Investment income	$14,100
Long-term capital gain on sale of stock	5,500
Investment counsel fees	3,000

Helen is unmarried and elects to itemize her deductions. She has no miscellaneous itemized deductions other than the investment counsel fees.

a. Determine Helen's investment interest deduction for 2010.
b. Discuss the treatment of the portion of Helen's investment interest that is disallowed in 2010.

24. **LO.9** In 2000, Stephen, who is single, purchased a personal residence for $400,000 and took out a mortgage of $250,000 on the property. In May of the current year, when the residence had a fair market value of $640,000 and Stephen owed $220,000 on the mortgage, he took out a home equity loan for $260,000. He used the funds to purchase a recreational vehicle, which he uses 100% for personal use. Write a letter to Stephen Upchurch at 4401 Montgomery Road, Kensington, OH 44427, and explain the maximum amount on which he can deduct home equity interest. COMMUNICATIONS

25. **LO.9** Pedro contributes a painting to an art museum in October of this year. He has owned the painting for 12 years, and it is worth $130,000 at the time of the donation. Pedro's adjusted basis for the painting is $90,000, and his AGI for the year is $250,000. Pedro has asked you whether he should make the reduced deduction election for this contribution. Write a letter to Pedro Valdez at 1289 Greenway Avenue, Foster City, CA 94404 and advise him on this matter. DECISION MAKING COMMUNICATIONS

26. **LO.9** In December each year, Alice Young contributes 10% of her gross income to the United Way (a 50% organization). Alice, who is in the 35% marginal tax bracket, is considering the following alternatives for satisfying the contribution. DECISION MAKING COMMUNICATIONS

	Fair Market Value
(1) Cash donation	$21,000
(2) Unimproved land held for six years ($3,000 basis)	21,000
(3) Blue Corporation stock held for eight months ($3,000 basis)	21,000
(4) Gold Corporation stock held for two years ($26,000 basis)	21,000

Alice has asked you to help her decide which of the potential contributions listed above will be most advantageous taxwise. Evaluate the four alternatives, and write a letter to Alice to communicate your advice to her. Her address is 2622 Bayshore Drive, Berkeley, CA 94709.

27. **LO.9** Ramon had AGI of $180,000 in 2010. He contributed stock in Charlton, Inc. (a publicly traded corporation), to the American Heart Association, a qualified charitable organization. The stock was worth $105,000 on the date it was contributed. Ramon had acquired it as an investment two years ago at a cost of $84,000. DECISION MAKING

a. Assuming that Ramon carries over any disallowed contribution from 2010 to future years, what is the total amount that he can deduct as a charitable contribution?
b. What is the maximum amount that Ramon can deduct as a charitable contribution in 2010?
c. What factors should Ramon consider in deciding how to treat the contribution for Federal income tax purposes?
d. Assume Ramon dies in December 2010. What advice would you give the executor of his estate with regard to possible elections that can be made relative to the contribution?

28. **LO.10** Ann and Bill were on the list of a local adoption agency for several years seeking to adopt a child. Finally, in 2009, good news comes their way and an adoption seems imminent. They pay qualified adoption expenses of $4,000 in 2009 and $11,000 in 2010. Assume the adoption becomes final in 2010. Ann and Bill always file a joint income tax return.

a. Determine the amount of the adoption expenses credit available to Ann and Bill assuming their combined annual income is $100,000. In what year(s) will they benefit from the credit?
b. Assuming Ann and Bill's modified AGI in 2009 and 2010 is $200,000, calculate the amount of the adoption expenses credit.

29. **LO.10** Paul and Karen are married, and both are employed (Paul earned $44,000 and Karen earned $7,100 during 2010). Paul and Karen have two dependent children, both under the age of 13. In order to work, Paul and Karen pay $4,200 to various unrelated parties to care for their children while they are working. Assuming that Paul and Karen file a joint return, what, if any, is their tax credit for child and dependent care expenses?

30. **LO.10** Jim and Mary Jean are married and have two dependent children under the age of 13. Both parents are gainfully employed and during 2010 earn salaries as follows: $16,000 (Jim) and $5,200 (Mary Jean). To care for their children while they work, they pay Eleanor (Jim's mother) $5,600. Eleanor does not qualify as a dependent of Jim and Mary Jean. Assuming Jim and Mary Jean file a joint tax return, what, if any, is their credit for child and dependent care expenses?

COMMUNICATIONS

31. **LO.10** Bernadette, a longtime client of yours, is an architect and president of the local Rotary chapter. To keep up to date with the latest developments in her profession, she attends continuing education seminars offered by the architecture school at State University. During 2010, Bernadette spends $2,000 on course tuition to attend such seminars. She also spends another $400 on architecture books during the year. Bernadette's son is a senior majoring in engineering at the University of the Midwest. During the 2010 calendar year, Bernadette's son incurs the following expenses: $8,200 for tuition ($4,100 per semester) and $750 for books and course materials. Bernadette's son, whom she claims as a dependent, lives at home while attending school full-time. Bernadette is married, files a joint return, and has a combined AGI with her husband of $103,000.
a. Calculate Bernadette's education tax credit for 2010.
b. In her capacity as president of the local Rotary chapter, Bernadette has asked you to make a 30–45 minute speech outlining the different ways the tax law helps defray (1) the cost of higher education and (2) the cost of continuing education once someone is in the workforce. Prepare an outline of possible topics for presentation. A tentative title for your presentation is "How Can the Tax Law Help Pay for College and Continuing Professional Education?"

32. **LO.10** Briefly discuss the requirements that must be satisfied for a taxpayer to qualify for the earned income tax credit.

ETHICS AND EQUITY

33. **LO.10** For many years, Loretta Johnson, a single mother of three children, has been struggling to make ends meet by working at two jobs that pay barely the minimum wage and together provide just over $15,000. Fortunately, her housing and food costs have been partially subsidized through various government programs. In addition, she has been able to take advantage of the earned income credit, which has provided around $3,000 annually to help her with living expenses. The credit has truly made a difference in the lives of Loretta and her family by helping them keep their creditors at bay. She is proud that she has worked hard and provided for her family for many years without having to accept welfare.

Now, however, Loretta faces a problem as her children have grown up and moved out of her home. With no qualifying children in her household, she no longer qualifies for the earned income credit. Although she will continue working at her two jobs, such a significant loss to her household budget cuts into her ability to be self-reliant. As a survival strategy and as a way of keeping the earned income credit, Loretta arranges to have one of her grandchildren live with her for just over six months every year. This enables a significant percentage of her household budget to be secure. How do you react to Loretta's strategy?

CRITICAL THINKING

DECISION MAKING

34. **LO.10** Joyce, a widow, lives in an apartment with her two minor children (ages 8 and 10) whom she supports. Joyce earns $33,000 during 2010. She uses the standard deduction.
a. Calculate the amount, if any, of Joyce's earned income credit.
b. During the year, Joyce is offered a new job that has greater future potential than her current job. If she accepts the job offer, her earnings for the year would be $39,000;

however, she is afraid she will not qualify for as much of the earned income credit. Using after-tax cash-flow calculations, determine whether Joyce should accept the new job offer.

PROBLEMS

35. Cory L. and Amber N. Fuller (ages 39 and 37) are married and live at 4380 Cottonwood Drive, Casper, WY 82609. Cory (Social Security No. 123–45–6782) is employed by the Natroma County public works department, while Amber (Social Security No. 123–45–6783) holds a part-time job with a nursing group that provides home care services to disabled persons.

TAX RETURN PROBLEM

DECISION MAKING

H&R BLOCK At Home

During 2009, the Fullers had the following receipts:

Salaries [$51,000 (Cory) + $39,000 (Amber)]		$90,000
Interest income—		
City of Cheyenne general purpose bonds	$2,100	
Chevron Corporation bonds	900	
CD issued by Wells Fargo Bank	1,300	4,300
Annual gift from Amber's parents		26,000
Bingo games sponsored by church [$1,000 (winnings) − $900 (losses)]		100
Loan repayment by Eric Fuller		10,000
Jury duty fees		800

The loan repayment was an interest-free loan Cory made to his brother five years ago to help pay for his wedding. In November 2009, Amber served on a jury and was paid $800 as a fee. Unfortunately, some of her expenses (see below) were not covered.

The Fullers had the following expenditures for 2009:

Medical expenses (not covered by insurance)		$1,800
Taxes—		
State and local sales taxes (receipts retained)	$1,900	
Property taxes on residence	5,000	6,900
Interest on home mortgage		3,100
Charitable contributions		3,600
Traditional IRA contribution (on Amber's behalf)		5,000
Expenses not covered in connection with jury service (parking)		60
Contribution to U.S. congressperson's reelection campaign		100

The Fullers maintain a household that includes the following: Matilda (Cory's widowed mother, age 66—Social Security No. 123–45–6781); Zelda (daughter, age 22—Social Security No. 123–45–6784); Eva, (daughter, age 19—Social Security No. 123–45–6785); and Perry (son, age 17—Social Security No. 123–45–6786). Except for the summer months, Zelda spent all of 2009 at a sorority house at Colorado State University where she is a full-time student. Her tuition is partly covered by a scholarship of $9,000. Eva graduated from high school in May 2009 and is uncertain about college. She earned $8,000 during the year modeling and deposited the money in a savings account.

Federal income tax withheld was $4,100 (Cory) and $3,000 (Amber). The appropriate amount of Social Security and Medicare tax was withheld. Determine the Federal income tax for 2009 for the Fullers on a joint return by completing the appropriate forms. They do not wish to contribute to the Presidential Election Campaign Fund. If an overpayment results, it is to be refunded to them. Suggested software: H&R BLOCK At Home.

36. Alice J. and Bruce M. Byrd are married taxpayers who file a joint return. Their Social Security numbers are 123–45–6789 and 111–11–1111, respectively. Alice's birthday is September 21, 1962, and Bruce's is June 27, 1961. They live at 473 Revere Avenue, Ames, MA 01850. Alice is the office manager for Ames Dental Clinic, 433 Broad Street, Ames, MA 01850 (employer identification number 98–765432). Bruce is the manager of a Super Burgers fast-food outlet owned and operated by Plymouth Corporation,

TAX RETURN PROBLEM

DECISION MAKING

H&R BLOCK At Home

1247 Central Avenue, Hauppauge, NY 11788 (employer identification number 11–1111111).

The following information is shown on their Wage and Tax Statements (Form W–2) for 2009.

Line	Description	Alice	Bruce
1	Wages, tips, other compensation	$54,000	$60,100
2	Federal income tax withheld	4,180	5,990
3	Social Security wages	54,000	60,100
4	Social Security tax withheld	3,348	3,726
5	Medicare wages and tips	54,000	60,100
6	Medicare tax withheld	783	871
15	State	Massachusetts	Massachusetts
16	State wages, tips, etc.	54,000	60,100
17	State income tax withheld	2,330	2,940

The Byrds provide over half of the support of their two children, Cynthia (born January 25, 1985, Social Security number 123–45–6788) and John (born February 7, 1989, Social Security number 123–45–6786). Both children are full-time students and live with the Byrds except when they are away at college. Cynthia earned $3,800 from a summer internship in 2009, and John earned $3,500 from a part-time job.

During 2009, the Byrds furnished 60% of the total support of Bruce's widower father, Sam Byrd (born March 6, 1933, Social Security number 123–45–6787). Sam lived alone and covered the rest of his support with his Social Security benefits. Sam died in November, and Bruce, the beneficiary of a policy on Sam's life, received life insurance proceeds of $750,000 on December 28.

The Byrds had the following expenses relating to their personal residence during 2009:

Property taxes	$4,870
Qualified interest on home mortgage	8,980
Repairs to roof	5,010
Utilities	3,580
Fire and theft insurance	1,840

The following facts relate to medical expenses for 2009:

Medical insurance premiums	$4,240
Doctor bill for Sam incurred in 2008 and not paid until 2009	7,545
Operation for Sam	7,450
Prescription medicines for Sam	1,075
Hospital expenses for Sam	3,350
Reimbursement from insurance company, received in 2009	3,500

The medical expenses for Sam represent most of the 60% Bruce contributed toward his father's support.

Other relevant information follows:

- When they filed their 2008 state return in 2009, the Byrds paid additional state income tax of $800.
- During 2009, Alice and Bruce attended a dinner dance sponsored by the Ames Police Disability Association (a qualified charitable organization). The Byrds paid $300 for the tickets. The cost of comparable entertainment would normally be $60.
- The Byrds contributed $4,900 to Ames Presbyterian Church and gave used clothing (cost of $1,200 and fair market value of $350) to the Salvation Army. All donations are supported by receipts and are in very good condition.

- In 2009, the Byrds received interest income of $2,700, which was reported on a Form 1099–INT from Second National Bank.
- Alice's employer requires that all employees wear uniforms to work. During 2009, Alice spent $447 on new uniforms and $206 on laundry charges.
- Bruce paid $360 for an annual subscription to the *Journal of Franchise Management.*
- Neither Alice's nor Bruce's employer reimburses for employee expenses.
- The Byrds do not keep the receipts for the sales taxes they paid and had no major purchases subject to sales tax.
- Alice and Bruce paid no estimated Federal income tax. Neither Alice nor Bruce wishes to designate $3 to the Presidential Election Campaign Fund.

In the interest of privacy and to protect against taxpayer identification misuse, Social Security numbers used throughout the textbook have been replaced with fictitious numbers.

Part 1—Tax Computation

Compute net tax payable or refund due for Alice and Bruce Byrd for 2009. If they have overpaid, they want the amount to be refunded to them. If you use tax forms for your computations, you will need Forms 1040 and 2106 and Schedules A and B. Suggested software: H&R BLOCK At Home.

Part 2—Tax Planning

Alice and Bruce are planning some significant changes for 2010. They have provided you with the following information and asked you to project their taxable income and tax liability for 2010.

The Byrds will invest the $750,000 of life insurance proceeds in short-term certificates of deposit (CDs) and use the interest for living expenses during 2010. They expect to earn total interest of $30,000 on the CDs.

Bruce has been promoted to regional manager, and his salary for 2010 will be $88,000. He estimates that state income tax withheld will increase by $4,000.

Alice, who has been diagnosed with a serious illness, will take a leave of absence from work during 2010. The estimated cost for her medical treatment is $15,200, of which $4,700 will be reimbursed by their insurance company in 2010.

John will graduate from college in December 2009 and will take a job in New York City in January 2010. His starting salary will be $41,200.

Assume all the information reported in 2009 will be the same in 2010 unless other information has been presented above.

37. Paul and Donna Decker are married taxpayers, ages 44 and 42, who file a joint return for 2010. The Deckers live at 1121 College Avenue, Carmel, IN 46032. Paul is an assistant manager at Carmel Motor Inn, and Donna is a teacher at Carmel Elementary School. They present you with W–2 forms that reflect the following information: **TAX COMPUTATION PROBLEM**

	Paul	Donna
Salary	$60,000	$61,000
Federal tax withheld	7,000	7,200
State income tax withheld	950	1,000
FICA (Social Security and Medicare) withheld	4,590	4,667
Social Security numbers*	111–11–1111	123–45–6789

*In the interest of privacy and to protect against taxpayer identification misuse, Social Security numbers used throughout the textbook have been replaced with fictitious numbers.

Donna is the custodial parent of two children from a previous marriage who reside with the Deckers through the school year. The children, Larry and Jane Parker, reside with their father, Bob, during the summer. Relevant information for the children follows:

	Larry	Jane
Age	17	18
Social Security numbers	123–45–6788	123–45–6787
Months spent with Deckers	9	9

Under the divorce decree, Bob pays child support of $200 per month per child during the nine months the children live with the Deckers. Bob says he spends $225 per month per child during the three summer months they reside with him. Donna and Paul can document that they provide $3,000 of support per child per year. The divorce decree is silent as to which parent can claim the exemptions for the children.

In August, Paul and Donna added a suite to their home to provide more comfortable accommodations for Hannah Snyder (Social Security number 123–45–6786), Donna's mother, who had moved in with them in February 2009 after the death of Donna's father. Not wanting to borrow money for this addition, Paul sold 300 shares of Acme Corporation stock for $50 per share on May 3, 2010, and used the proceeds of $15,000 to cover construction costs. The Deckers had purchased the stock on April 29, 2005, for $30 per share. They received dividends of $800 on the jointly owned stock a month before the sale.

Hannah, who is 66 years old, received $7,500 in Social Security benefits during the year, of which she gave the Deckers $2,500 to use toward household expenses and deposited the remainder in her personal savings account. The Deckers determine that they have spent $3,000 of their own money for food, clothing, medical expenses, and other items for Hannah. They do not know what the rental value of Hannah's suite would be, but they estimate it would be at least $300 per month.

Interest paid during the year included the following:

Home mortgage interest (paid to Carmel Federal Savings and Loan)	$8,000
Interest on an automobile loan (paid to Carmel National Bank)	1,490
Interest on Citibank Visa card	870

In July, Paul hit a submerged rock while boating. Fortunately, he was thrown from the boat, landed in deep water, and was uninjured. However, the boat, which was uninsured, was destroyed. Paul had paid $25,000 for the boat in June 2009, and its value was appraised at $18,000 on the date of the accident.

The Deckers paid doctor and hospital bills of $9,000 and were reimbursed $2,100 by their insurance company. They spent $700 for prescription drugs and medicines and $2,810 for premiums on their health insurance policy. They have filed additional claims of $1,200 with their insurance company and have been told they will receive payment for that amount in January 2011. Included in the amounts paid for doctor and hospital bills were payments of $380 for Hannah and $850 for the children.

Additional information of potential tax consequence follows:

Real estate taxes paid	$3,700
Sales taxes paid (per table)	1,379
Contributions to church	4,500
Appraised value of books donated to public library	750
Paul's unreimbursed employee expenses to attend hotel management convention:	
Airfare	840
Hotel	270
Meals	125
Registration fee	340
Refund of state income tax for 2009 (the Deckers itemized on their 2009 Federal tax return)	1,600

Compute net tax payable or refund due for the Deckers for 2010. Ignore the child tax credit in your computations. If they have overpaid, the amount is to be credited toward their taxes for 2011.



1. George comes to you asking for your advice. He wishes to invest $10,000 either in a debt security or in an equity investment. His choices are as shown below:

   - Redbreast Corporation bond, annual coupon rate of 7.50%.
   - City of Philadelphia general obligation bond, coupon rate of 6.00%.
   - Blue Corporation 7.50% preferred stock (produces qualified dividend income).

   These alternatives are believed to carry comparable risk. Assuming George is in the 35% marginal tax bracket, which investment alternative could be expected to produce the superior annual after-tax rate of return?

2. Assume the same facts as in Problem 1, except that George is a C corporation rather than an individual and is in the 34% marginal tax bracket. Which investment strategy would maximize George, Inc.'s annual return?

RESEARCH PROBLEMS

Note: Solutions to Research Problems can be prepared by using the **Checkpoint® Student Edition** online research product, which is available to accompany this text. It is also possible to prepare solutions to the Research Problems by using tax research materials found in a standard tax library.

THOMSON REUTERS
Checkpoint® Student Edition

COMMUNICATIONS

Research Problem 1. Don and Mary Dewey are successful professionals and have a combined AGI of approximately $400,000. Their household includes two children: Debra (age 16) and Van (age 23). Van is not a student but works at a part-time job where he earns $16,000. Don has heard that it might be beneficial if Van, rather than Don and Mary, claims Debra as a qualified child for income tax purposes. At a local Chamber of Commerce meeting, he asks you to advise him on this matter. Send a letter to Don at 4321 Mount Vernon Road, Dover, DE 19901, advising him about the advantages of such a choice and whether it is feasible. In your letter, discuss the relevance of Code §§ 24, 32, 151, and 152.

Research Problem 2. Bernice and Nate were divorced on July 7, 2009. Under the divorce decree, Bernice received full custody of their three children, and Nate was awarded the dependency exemptions for them. After the trial was over, Nate had Bernice sign a Form 8332 (Release/Revocation of Release of Claim to Exemption for Child by Custodial Parent) releasing her rights to the dependency exemptions for the next five years. In early April 2010, Bernice realizes the tax costs of losing the deduction for the dependency exemptions. Besides contacting Nate, who is already delinquent in his child support payments, does she have any way out?

Research Problem 3. As a result of an automobile accident, Marco suffered physical injuries and incurred $100,000 in medical expenses. The other party was at fault but had no insurance or assets. Therefore, Marco attempted to collect on his own automobile insurance policy that included "uninsured motorist protection." At first, the insurance company, refused to pay because of a provision in the policy. However, Marco and other policyholders filed a class-action breach of contract lawsuit against the insurer. The insurance company settled the lawsuit, and Marco received $100,000. Marco did not include the $100,000 in his gross income because, according to him, the payment was received on account of his personal physical injuries. The IRS contends instead that the amount was received for breach of contract and therefore cannot be excluded from gross income. You recall that a taxpayer in Tucson, Arizona, litigated the tax issue, but you cannot remember what the court held. Locate the case and explain how the outcome in the Tucson case should affect Marco's position on the issue.

COMMUNICATIONS

Research Problem 4. Josef Abrams, an attorney, paid $30,000 during the year for his children to attend Jewish schools. On his tax return, Abrams deducted $18,000, based on the argument that 60% of his children's instruction was religious and that payments related to that type of instruction constituted contributions to the temple for conducting its religious functions. He did not attempt to deduct the 40% of the tuition that was related to secular education. Further, Abrams argued that the IRS had allowed members of the Church of

Scientology to deduct the portion of fees paid to the church that were related to religious education, and that disallowance of his deduction would constitute unequal application of the law. Write a letter to Mr. Abrams explaining whether the $18,000 is deductible or nondeductible. He lives at 122 Southmoor, Stamford, CT 06902.



Use the tax resources of the Internet to address the following questions. Do not restrict your search to the Web, but include a review of newsgroups and general reference materials, practitioner sites and resources, primary sources of the tax law, chat rooms and discussion groups, and other opportunities.

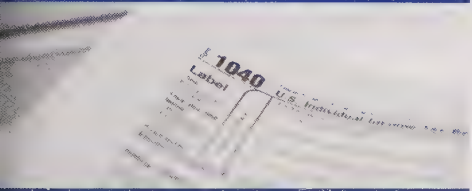
COMMUNICATIONS

Research Problem 5. Go to the IRS site on the Internet and download instructions and Regulations relative to educational savings bonds and qualified tuition programs. Summarize one of the key provisions in these materials in outline format.

Research Problem 6. The IRS has unveiled a web-based tool to help taxpayers determine whether they or their clients are eligible for the earned income credit. Locate this tool at the IRS website and then apply the facts related to a hypothetical taxpayer and determine if the earned income credit is available.

CHAPTER 17

Individuals as Employees and Proprietors



LEARNING OBJECTIVES

After completing Chapter 17, you should be able to:

LO.1 Distinguish between **employee and self-employed status.** **(pp. 17-3 to 17-5)**

LO.2 Understand the **exclusions from income available to employees** who receive fringe benefits. **(pp. 17-5 to 17-19)**

LO.3 Apply the rules for computing **deductible expenses of employees** including transportation, travel, moving, education, and entertainment expenses. **(pp. 17-19 to 17-36)**

LO.4 Appreciate the difference between **accountable and nonaccountable employee plans** and understand the opportunities to build wealth through individual retirement accounts. **(pp. 17-36 to 17-42)**

LO.5 Understand the **tax provisions applicable to proprietors.** **(pp. 17-42 to 17-50)**

LO.6 Distinguish between business and hobby activities and apply the rules limiting the deduction of **hobby losses.** **(pp. 17-50 to 17-52)**

TAX *Talk*

The taxpayer—that's someone who works for the Federal government but doesn't have to take a civil service examination.

—RONALD REAGAN

OUTLINE

17.1 Employee versus Self-Employed, 17-3
Factors Considered in Classification, 17-4
17.2 Exclusions Available to Employees, 17-5
Advantages of Qualified Fringe Benefits, 17-5
Employer-Sponsored Accident and Health Plans, 17-6
Medical Reimbursement Plans, 17-6
Long-Term Care Benefits, 17-7
Meals and Lodging Furnished for the Convenience of the Employer, 17-8
Group Term Life Insurance, 17-10
Qualified Tuition Reduction Plans, 17-11
Other Specific Employee Fringe Benefits, 17-11
Cafeteria Plans, 17-12
Flexible Spending Plans, 17-13
General Classes of Excluded Benefits, 17-13
Taxable Fringe Benefits, 17-18
Foreign Earned Income, 17-18
17.3 Employee Expenses, 17-19
Transportation Expenses, 17-20
Travel Expenses, 17-22
Moving Expenses, 17-25
Education Expenses, 17-28
A Limited Deduction Approach, 17-30
Entertainment Expenses, 17-31
Other Employee Expenses, 17-33
Classification of Employee Expenses, 17-36
Contributions to Individual Retirement Accounts, 17-38
17.4 Individuals as Proprietors, 17-42
The Proprietorship as a Business Entity, 17-42
Income of a Proprietorship, 17-43
Deductions Related to a Proprietorship, 17-43
Retirement Plans for Self-Employed Individuals, 17-45
Accounting Periods and Methods, 17-48
Estimated Tax Payments, 17-48
17.5 Hobby Losses, 17-50
General Rules, 17-50
Presumptive Rule of § 183, 17-50
Determining the Amount of the Deduction, 17-51

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SELF-EMPLOYED VERSUS EMPLOYEE—WHAT'S THE DIFFERENCE?

Mark and Mary Herman come to you for tax advice. Mark Herman is a self-employed consultant. Last year, Mark's business generated revenue of $125,000 and incurred expenses of $18,000 for rent and utilities for an office. Mark also spent $8,000 purchasing depreciable equipment used in the business and paid a part-time secretary $12,000 for administrative work performed during the year. Mark paid $3,000 for his own health insurance and $500 for term life insurance; he did not contribute to any retirement plans. Mary (Mark's wife) also works as a consultant but is employed by a large firm. Her salary last year was $85,000. Mary's employer paid $3,000 of premiums for her health insurance and provided $50,000 of group term life insurance to each of its employees. Mary is not covered by a qualified retirement plan at work but contributed $5,000 to a traditional IRA. Mary routinely travels for her job and was reimbursed by her employer for all travel expenses. In addition, Mary spent $500 on other employee business expenses that were not reimbursed by her employer.

What are the tax consequences of these items? Can Mark and Mary deduct the expenses they incurred? Are there other tax planning opportunities that the couple may be missing or tax issues of which they should be aware? **Read the chapter and formulate your response.**

An individual may be an employee or may be self-employed. The terms *proprietor* and *independent contractor* are both used to describe self-employed individuals. These terms are used interchangeably throughout this chapter.

In many cases, it is difficult to distinguish between employees and self-employed individuals. This chapter begins with a discussion of the factors that must be considered in determining whether an individual is an employee or is self-employed. This is followed by a discussion of tax provisions applicable to employees and then by a discussion of tax provisions related to self-employed individuals.



Bridge to Equity or Fairness and Business Law

Max performs services for Calico, Inc. Amy performs services for Amber, Inc. They perform basically the same service. Yet Max is classified as an employee, and Amy is classified as an independent contractor. Does such a legal classification produce equitable results in terms of the effects it has on Max and Amy?

Employee status produces a number of potential perks. Included are coverage in the employer's fringe benefits programs such as medical insurance, group term life insurance, and § 132 fringe benefits. For an employee, the tax rate for Social Security is 6.2 percent and for Medicare, the rate is 1.45 percent (i.e., the employer is responsible for matching the employee amounts). For a self-employed person, the tax rates for Social Security and Medicare are 12.4 percent and 2.9 percent, respectively.

In distinguishing between an employee and an independent contractor, the overriding theme of common law is that the employee is subject to the will and control of the employer both as to what is to be done and as to how it is to be done. Put in more legal terminology, an employer has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which the result is accomplished. Among the factors generally considered in determining whether this right exists are the following:

- Degree of control exercised over the details of the work.
- Provision of facilities used in the work.
- Opportunity for profit or loss.
- Right to discharge.
- Whether work is part of regular business.
- Permanency of the relationship.
- Relationship that the parties believe they are creating.
- Manner of payment, by the job or by the hour.
- Skill required.
- Offering of the services to the general public rather than to one individual or entity.
- Distinct occupation or recognized trade or calling involved.
- Custom in the trade.

17.1 Employee versus Self-Employed

LO.1

Distinguish between employee and self-employed status.

When one person performs services for another, the person performing the service is either an employee or self-employed (i.e., an **independent contractor**). Failure to recognize employee status can have serious consequences. Tax deficiencies as well as interest and penalties may result.

The determination of employment status is already controversial and can be expected to become an even greater problem in the future. As a means for achieving greater flexibility and cost control, businesses are increasingly relying on self-employed persons (i.e., independent contractors) rather than employees for many services.

The IRS is very much aware that businesses have a tendency to wrongly classify workers as self-employed rather than as employees. In some cases, misclassification is unintentional and results from difficulty in applying the complex set of rules related to employee versus independent contractor status. In other cases, misclassification may be an intentional strategy to avoid certain costs that are associated with employees. Unlike employees, self-employed persons do not have to be included in various fringe benefit programs and retirement plans. Furthermore, employers are not required to pay FICA and unemployment taxes (refer to Chapter 1) on compensation paid to independent contractors.

In terms of tax consequences, employment status also makes a great deal of difference to the worker. Allowable business expenses of self-employed taxpayers are classified as deductions *for* AGI and are reported on Schedule C (Profit or Loss from Business) of Form 1040.[1] On the other hand, unreimbursed business expenses incurred by employees are classified as itemized deductions and are deductible on Schedule A (as itemized deductions) only to the extent that the sum of certain miscellaneous itemized deductions exceeds 2 percent of the taxpayer's AGI. Unreimbursed employee expenses are reported on Form 2106 (Employee Business Expenses) and Schedule A (Itemized Deductions) of Form 1040.

[1] §§ 62(a)(1) and 162(a).

TAX in the NEWS

Self-Employed or Employed? Misclassification Can Be Costly!

Approximately a decade ago, the media sensation was the number of prominent persons who had run afoul of the so-called nanny tax. Simply stated, this meant not complying with payroll procedures applicable to domestics, baby sitters, and other household employees. This failure to comply with the tax law forced a President Clinton nominee for U.S. Attorney General, Zoe Baird, to withdraw from consideration. The publicity generated by this case, and others like it, had a sobering effect on the taxpaying public. By 1997, as many as 310,000 nanny tax forms (Schedule H, Form 1040) were being filed. Since then, however, the number of such returns has steadily declined. In 2001, for example, a new low of 263,000 was reached. This downward trend has continued with a new low of 239,810 nanny tax returns being filed in 2003.

What does this decline signify? Does it mean that a greater number of these household helpers are now self-employed (i.e., independent contractors) so as to be exempt from employee payroll procedures? Or does it mean that many taxpayers have forgotten about Zoe Baird and her costly lesson?

The Bernard Kerik incident in December 2004 must have been a touch of déjà vu. Nominated by President Bush to be head of Homeland Security, Kerik felt compelled to withdraw when it came to light that he had employed an illegal immigrant as a nanny. Ironically, as Secretary of Homeland Security, he would have overseen the enforcement of the nation's immigration laws. Furthermore, Kerik had compounded the wrongdoing by not paying any employment taxes on the wages earned by the nanny.

The moral of the story? If you aspire to a high-profile government appointment, avoid the nannygate trap!

Employee expenses that are reimbursed under an **accountable plan** (covered later in this chapter) are also reported as deductions *for* AGI. Employee expenses that are not reimbursed under an accountable plan are treated in the same way as unreimbursed expenses—deductible *from* AGI and limited to the excess over 2 percent of AGI.[2]

FACTORS CONSIDERED IN CLASSIFICATION

The pivotal issue in classifying an individual as an independent contractor or an employee is whether an employer-employee relationship exists. The IRS has created a complex *20-factor test* for determining whether a worker is an employee or an independent contractor. The courts, which have focused on a small number of these factors, generally hold that an individual is an employee if the individual or business acquiring the services:[3]

- has the right to specify the end result and the ways and means by which that result is to be attained,
- can exert will and control over the person providing the services with respect not only to *what* shall be done but also to *how* it shall be done,
- has the right to discharge, without legal liability, the person performing the service,
- furnishes tools or a place to work, and
- bases payment on time spent rather than the task performed.

Each case is tested on its own merits, and the right to control the means and methods of accomplishment is the definitive test. Generally, physicians, lawyers, dentists, contractors, subcontractors, and others who offer services to the public are not classified as employees.

DIGGING DEEPER 1

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

[2] § 67(a). [3] Reg. § 31.3401(c)–(1)(b).

Tax Planning Strategies SELF-EMPLOYED INDIVIDUALS

FRAMEWORK FOCUS: DEDUCTIONS

Strategy: Maximize Deductible Amounts.

Some taxpayers have the flexibility to be classified as either employees or self-employed individuals. Examples include real estate agents and direct sellers. These taxpayers should carefully consider all factors and not automatically assume that self-employed status is preferable.

It is advantageous to deduct one's business expenses *for* AGI and avoid the 2 percent floor for miscellaneous itemized deductions. However, a self-employed individual may incur additional expenses, such as local gross receipts taxes, license fees, franchise fees, personal property taxes, and occupation taxes. Record-keeping and filing requirements can also be quite burdensome.

One of the most expensive considerations is the **self-employment tax** imposed on independent contractors and other self-employed individuals. For an employee in 2010, for example, the Social Security tax applies at a rate of 6.2 percent on a base amount of wages of $106,800, and the Medicare tax applies at a rate of 1.45 percent with no limit on the base amount. For self-employed persons, the rate, but not the base amount, for each tax doubles. Even though a deduction *for* AGI is allowed for one-half of the self-employment tax paid, an employee and a self-employed individual are not in the same tax position on equal amounts of earnings. For the applicability of these taxes to workers, see Chapter 1.

After analyzing all these factors, taxpayers in many cases may decide that employee status is preferable to self-employed status.

EXAMPLE 1

Arnold is a lawyer whose major client accounts for 60% of his billings. He does the routine legal work and income tax returns at the client's request. He is paid a monthly retainer in addition to amounts charged for extra work. Arnold is a self-employed individual. Even though most of his income comes from one client, he still has the right to determine *how* the end result of his work is attained. ■

EXAMPLE 2

Ellen is a lawyer hired by Arnold to assist him in the performance of services for the client mentioned in Example 1. Ellen is under Arnold's supervision; he reviews her work and pays her an hourly fee. Ellen is Arnold's employee. ■

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.



17.2 EXCLUSIONS AVAILABLE TO EMPLOYEES

LO.2

Understand the exclusions from income available to employees who receive fringe benefits.

Several exclusions that are available to *all taxpayers* were discussed in Chapter 4; these include interest on obligations of state and local governments, life insurance proceeds, and income from discharge of indebtedness. Other exclusions, available only to *individuals*, were discussed in Chapter 16; these exclusions include gifts and inheritances, scholarships, and compensation for injuries and sickness. Exclusions available only to *employees* are discussed below.

ADVANTAGES OF QUALIFIED FRINGE BENEFITS

Exclusions available only to *employees* are generally referred to as *qualified fringe benefits*. The popularity of fringe benefits is attributable to the fact that the cost of such benefits is deductible by employers and excludible by employees.

EXAMPLE 3

Cardinal Corporation, which has a marginal tax rate of 35%, provides health insurance coverage to employees at a cost of $1,000 per employee. Because Cardinal can deduct the health insurance premiums paid to provide this coverage, the net cost to the

corporation is $650 per employee ($1,000 cost – $350 tax savings). The employee is allowed to exclude the value of this fringe benefit, so there is no tax cost to the employee.

The average employee of Cardinal Corporation is in the 28% bracket. If Cardinal did not provide the health insurance coverage and the employee paid a $1,000 premium, the employee would have to use after-tax dollars to acquire the coverage. The employee would have to earn $1,389 to pay for the coverage [$1,389 wages – ($1,389 × 28% tax)]. The after-tax cost to the corporation of $1,389 in wages is $903 ($1,389 wages – $486 corporate tax savings). Thus, the cost of health insurance coverage is $253 less per employee ($903 – $650) because it is both deductible by the corporation and excludible by the employee. ■

EMPLOYER-SPONSORED ACCIDENT AND HEALTH PLANS

Congress encourages employers to provide employees, retired former employees, and their dependents with accident and health benefits, disability insurance, and long-term care plans. The *premiums* are deductible by the employer and are excluded from the employee's gross income.[4] Although § 105(a) provides the general rule that the employee has includible income when he or she collects the insurance *benefits*, two exceptions are provided.

Section 105(b) generally excludes payments received for medical care of the employee, spouse, and dependents. However, if the payments are for expenses that do not meet the Code's definition of medical care,[5] the amount received must be included in gross income. In addition, the taxpayer must include in gross income any amounts received for medical expenses that were deducted by the taxpayer on a prior return.

EXAMPLE 4

Tab's employer-sponsored health insurance plan paid $4,000 for hair transplants that did not meet the Code's definition of medical care. Tab must include the $4,000 in his gross income. ■

Section 105(c) excludes payments for the permanent loss or the loss of the use of a member or function of the body or the permanent disfigurement of the employee, spouse, or a dependent. However, payments that are a substitute for salary (e.g., related to the period of time absent) are included in income.

EXAMPLE 5

Jill lost an eye in an automobile accident unrelated to her work. As a result of the accident, Jill incurred $2,000 of medical expenses, which she deducted on her return. She collected $10,000 from an accident insurance policy carried by her employer. The benefits were paid according to a schedule of amounts that varied with the part of the body injured (e.g., $10,000 for loss of an eye, $20,000 for loss of a hand). Because the payment was for loss of a *member or function of the body*, the $10,000 is excluded from Jill's gross income. Jill was absent from work for a week as a result of the accident. Her employer also provided her with insurance that reimbursed her for the loss of income due to illness or injury. Jill collected $500, which is includible in her gross income. ■

MEDICAL REIMBURSEMENT PLANS

As noted above, the amounts received through the insurance coverage (insured plan benefits) are excluded from gross income under § 105. Unfortunately, because of cost considerations, the insurance companies that issue this type of policy usually require a broad coverage of employees. An alternative is to have a plan that is not funded with insurance (a self-insured arrangement). Under a self-insured plan, the employer reimburses employees directly for any medical expenses. The benefits received under a self-insured plan can be excluded from the employee's gross income, if the plan does not discriminate in favor of highly compensated employees.

[4] § 106, Reg. § 1.106–1, and Rev.Rul. 82–196, 1982–1 C.B. 106.

[5] See the discussion of medical care in Chapter 16.



Bridge to Economic and Societal Needs

The media frequently report on the plight of our "senior citizens." Organizations such as the AARP effectively lobby for the rights of senior citizens through direct lobbying in Washington and through grassroots efforts throughout the country. With the graying of America, these concerns and lobbying efforts are likely to be magnified.

Congress, in the 1930s, enacted Social Security to partially provide for the retirement needs of our senior citizens. In the 1960s, Congress enacted Medicare to partially provide for the medical needs of our senior citizens.

The Internal Revenue Code contains a number of provisions that are "senior citizen friendly." Among these are the following:

- General exclusion, except for the "rich," of Social Security benefits from gross income (§ 86).
- Exclusion of life insurance proceeds from the gross income of the recipient (§ 101).
- Exclusion of medical insurance premiums and benefits from gross income (§ 105 and § 106).
- Limited exclusion from gross income of gain on the sale of a principal residence (§ 121).
- Limited exclusion from gross income of long-term care insurance premiums and benefits (§ 7702B).
- Beneficial treatment of retirement plans (Subchapter D).

Archer **Medical Savings Accounts (MSAs)** provided an alternative means of accomplishing a medical reimbursement plan. The MSA had two parts: catastrophic insurance coverage that kicked in after the deductible had been paid, and a savings account that could be tapped to pay the deductible and any uncovered medical expenses.

Legislation enacted in 2003 created the **Health Savings Account (HSA)**, which broadened the concept of MSAs and extended it to a larger set of taxpayers.[6] See additional discussion in Chapter 16.

LONG-TERM CARE BENEFITS

Generally, long-term care insurance, which covers expenses such as the cost of care in a nursing home, is treated the same as accident and health insurance benefits. Thus, the employee does not recognize income when the employer pays the premiums. This exclusion is subject to annual limits as follows:

Insured's Age before Close of Tax Year	2009	2010
40 or less	$ 320	$ 330
41 to 50	600	620
51 to 60	1,190	1,230
61 to 70	3,180	3,290
More than 70	3,980	4,110

When benefits are received from the policy, whether the employer or the individual purchased the policy, the exclusion from gross income is limited to the *greater* of the following amounts:

- $290 (indexed amount for 2010) for each day the patient receives the long-term care.
- The actual cost of the care.

The excludible amount is reduced by any amounts received from other third parties (e.g., damages received).[7]

[6] § 223.

[7] § 7702B.

Hazel, who suffers from Alzheimer's disease, was a patient in a nursing home for the last 30 days of 2010. While in the nursing home, she incurred total costs of $7,600. Medicare paid $3,200 of the costs. Hazel received $6,000 from her long-term care insurance policy (which paid $200 per day while she was in the facility). The amount Hazel may exclude is calculated as follows:

Greater of:		
Daily statutory amount of $290 ($290 × 30 days)	$8,700	
Actual cost of the care	7,600	$ 8,700
Less: Amount received from Medicare		(3,200)
Amount of exclusion		$ 5,500

Therefore, Hazel must include $500 ($6,000 − $5,500) of the long-term care benefits received in her gross income. ■

The exclusion for long-term care insurance is not available if it is provided as part of a cafeteria plan or a flexible spending plan (discussed later in this chapter).

MEALS AND LODGING FURNISHED FOR THE CONVENIENCE OF THE EMPLOYER

Income can take any form, including meals and lodging. However, § 119 excludes from gross income the value of meals and lodging provided to the employee and the employee's spouse and dependents under the following conditions:[8]

- The meals and/or lodging are *furnished by the employer*, on the employer's *business premises*, for the *convenience of the employer.*
- In the case of lodging, the *employee is required* to accept the lodging as a condition of employment.

The courts have construed these requirements strictly, as discussed below.

Furnished by the Employer

The following two questions have been raised with regard to the *furnished by the employer* requirement:

- Who is considered an *employee?*
- What is meant by *furnished?*

For the employee issue, the IRS and some courts have reasoned that because a partner is not an employee, the exclusion does not apply to a partner. However, the Tax Court and the Fifth Circuit Court of Appeals have ruled in favor of the taxpayer on this issue.[9]

On the issue of whether meals and lodging are *furnished* by the employer, the Supreme Court held that a *cash meal allowance* was ineligible for the exclusion because the employer did not actually furnish the meals.[10] Similarly, one court denied the exclusion where the employer paid for the food and supplied the cooking facilities but the employee prepared the meal.[11]

On the Employer's Business Premises

The *on the employer's business premises* requirement, applicable to both meals and lodging, has resulted in much litigation. The Regulations define business premises as simply "the place of employment of the employee."[12] Thus, the Sixth Circuit Court

[8] § 119(a). The value of meals and lodging is also excluded from FICA and FUTA tax. *Rowan Companies, Inc. v. U.S.*, 81–1 USTC ¶9479, 48 AFTR 2d 81–5115, 101 S.Ct. 2288 (USSC, 1981).

[9] Rev.Rul. 80, 1953–1 C.B. 62; *Comm. v. Doak*, 56–2 USTC ¶9708, 49 AFTR 1491, 234 F.2d 704 (CA–4, 1956); but see *G. A. Papineau*, 16 T.C. 130 (1951); *Armstrong v. Phinney*, 68–1 USTC ¶9355, 21 AFTR 2d 1260, 394 F.2d 661 (CA–5, 1968).

[10] *Comm. v. Kowalski*, 77–2 USTC ¶9748, 40 AFTR 2d 6128, 98 S.Ct. 315 (USSC, 1977).

[11] *Tougher v. Comm.*, 71–1 USTC ¶9398, 27 AFTR 2d 1301, 441 F.2d 1148 (CA–9, 1971).

[12] Reg. § 1.119–1(c)(1).

of Appeals held that a residence, owned by the employer and occupied by an employee, located two blocks from the motel that the employee managed was not part of the business premises.[13] However, the Tax Court considered an employer-owned house located across the street from the hotel that was managed by the taxpayer to be on the business premises of the employer.[14] Perhaps these two cases can be reconciled by comparing the distance from the lodging facilities to the place where the employer's business was conducted. The closer the lodging to the business operations, the more likely the convenience of the employer is served.

For the Convenience of the Employer

The *convenience of the employer* test is intended to focus on the employer's motivation for furnishing the meals and lodging rather than on the benefits received by the employee. If the employer furnishes the meals and lodging primarily to enable the employee to perform his or her duties properly, it does not matter that the employee considers these benefits to be a part of his or her compensation.

The Regulations give the following examples in which the tests for excluding meals are satisfied:[15]

- A waitress is required to eat her meals on the premises during the busy lunch and breakfast hours.
- A bank furnishes a teller meals on the premises to limit the time the employee is away from his or her booth during the busy hours.
- A worker is employed at a construction site in a remote part of Alaska. The employer must furnish meals and lodging due to the inaccessibility of other facilities.

If more than half of the meals provided to employees are furnished for the convenience of the employer, then all such employee meals are treated as provided for the convenience of the employer. Thus, in this situation, all employees are treated the same (either all of the employees are allowed exclusion treatment, or none of the employees can exclude the meals from gross income).

EXAMPLE 7

Allison's Restaurant has a restaurant area and a bar. Nine employees work in the restaurant and three work in the bar. All of the employees are provided one meal per day. In the case of the restaurant workers, the meals are provided for the convenience of the employer. The meals provided to the bar employees do not satisfy the convenience of the employer requirement. Because more than half of the employees receive their meal for the convenience of the employer, all 12 employees qualify for exclusion treatment. ■

Required as a Condition of Employment

The *required as a condition of employment* test applies only to lodging. If the employee's use of the housing would serve the convenience of the employer, but the employee is not required to use the housing, the exclusion is not available.

EXAMPLE 8

VEP, a utilities company, has all of its service personnel on 24-hour call for emergencies. The company encourages its employees to live near the plant so they can respond quickly to emergency calls. Company-owned housing is available rent-free. Only 10 of the employees live in the company housing because it is not suitable for families.

Although the company-provided housing serves the convenience of the employer, it is not required. Therefore, the employees who live in the company housing must include its value in gross income. ■

In addition, if the employee has the option of cash or lodging, the employer-required test is not satisfied.

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[13] *Comm. v. Anderson*, 67–1 USTC ¶9136, 19 AFTR 2d 318, 371 F.2d 59 (CA–6, 1966).

[14] *J. B. Lindeman*, 60 T.C. 609 (1973).

[15] Reg. § 1.119–1(f).

TABLE 17.1 Uniform Premiums for $1,000 of Group Term Life Insurance Protection

5-Year Age Bracket	Cost of $1,000 of Protection for a One-Month Period*
Under 25	$ .05
25–29	.06
30–34	.08
35–39	.09
40–44	.10
45–49	.15
50–54	.23
55–59	.43
60–64	.66
65–69	1.27
70 and above	2.06

*Reg. § 1.79–3, effective for coverage after June 30, 1999.

EXAMPLE 9 Khalid is the manager of a large apartment complex. The employer gives Khalid the option of rent-free housing (value of $9,600 per year) or an additional $7,500 per year. Khalid selects the housing option. Therefore, he must include $9,600 in gross income. ■

Other housing exclusions are available for certain employees of educational institutions, ministers of the gospel, and military personnel.

GROUP TERM LIFE INSURANCE

For many years, the IRS did not attempt to tax the value of life insurance protection provided to an employee by the employer. Some companies took undue advantage of the exclusion by providing large amounts of insurance protection for key executives. In response, Congress enacted § 79, which created a limited exclusion for group term life insurance. Current law allows an exclusion of premiums on the first $50,000 of group term life insurance protection.

The benefits of this exclusion are available only to employees. Proprietors and partners are not considered employees. Moreover, the Regulations generally require broad-scale coverage of employees to satisfy the group requirement (e.g., shareholder-employees would not constitute a qualified group). The exclusion applies only to term insurance (protection for a period of time but with no cash surrender value) and not to ordinary life insurance (lifetime protection plus a cash surrender value that can be drawn upon before death).

As mentioned, the exclusion applies to the first $50,000 of group term life insurance protection. For each $1,000 of coverage in excess of $50,000, the employee must include the amounts indicated in Table 17.1 in gross income.[16]



In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

EXAMPLE 10 Finch Corporation has a group term life insurance policy with coverage equal to the employee's annual salary. Keith, age 52, is president of the corporation and receives an

[16]Reg. § 1.79–3(d)(2).

annual salary of $75,000. Keith must include $69 in gross income from the insurance protection for the year.

$$[(\$75{,}000 - \$50{,}000)/\$1{,}000] \times \$0.23 \times 12 \text{ months} = \$69$$ ■

If the plan discriminates in favor of certain key employees (e.g., officers), the key employees are not eligible for the exclusion. In such a case, the key employees must include in gross income the *greater* of actual premiums paid by the employer or the amount calculated from the Uniform Premiums table in Table 17.1. The other employees are still eligible for the $50,000 exclusion and continue to use the Uniform Premiums table to compute the income from excess insurance protection.[17]

QUALIFIED TUITION REDUCTION PLANS

Employees (including retired and disabled former employees) of nonprofit educational institutions are allowed to exclude a tuition waiver from gross income, if the waiver is pursuant to a qualified tuition reduction plan.[18] The plan may not discriminate in favor of highly compensated employees. The exclusion applies to the employee, the employee's spouse, and the employee's dependent children. The exclusion also extends to tuition reductions granted by any nonprofit educational institution to employees of any other nonprofit educational institution (reciprocal agreements).

ABC University allows the dependent children of XYZ University employees to attend ABC University with no tuition charge. XYZ University grants reciprocal benefits to the children of ABC University employees. The dependent children can also attend tuition-free the university where their parents are employed. Employees who take advantage of these benefits are not required to recognize gross income. ■

Generally, the exclusion is limited to undergraduate tuition waivers. However, in the case of teaching or research assistants, graduate tuition waivers may also qualify for exclusion treatment. According to the Proposed Regulations, the exclusion is limited to the value of the benefit in excess of the employee's reasonable compensation.[19] Thus, a tuition reduction that is a substitute for cash compensation cannot be excluded.

Susan is a graduate research assistant. She receives a $5,000 salary for 500 hours of service over a nine-month period. This pay, $10 per hour, is reasonable compensation for Susan's services. In addition, Susan receives a waiver of $6,000 for tuition. Susan may exclude the tuition waiver from gross income. ■

OTHER SPECIFIC EMPLOYEE FRINGE BENEFITS

Congress has enacted exclusions to encourage employers to (1) finance and make available child care facilities, (2) provide athletic facilities for employees, (3) finance certain education expenses of employees, and (4) assist employees who adopt children. These provisions are summarized as follows:

- The employee can exclude from gross income the value of child and dependent care services paid for by the employer and incurred to enable the employee to work. The exclusion cannot exceed $5,000 per year ($2,500 if married and filing separately). For a married couple, the annual exclusion cannot exceed the earned income of the spouse who has the lesser amount of earned income. For an unmarried taxpayer, the exclusion cannot exceed the taxpayer's earned income.[20]

[17] § 79(d).
[18] § 117(d).
[19] Prop.Reg. § 1.117–6(d).
[20] § 129. The exclusion applies to the same types of expenses that, if paid by the employee (and not reimbursed by the employer), would be eligible for the credit for child and dependent care expenses, discussed in Chapter 16.

TAX in the NEWS

Employee Tuition Assistance Offers Benefits to Employers Too

Some employers are reluctant to provide college tuition assistance to employees because they fear that the employees may use the benefits to enhance their qualifications so that they can find a job with another employer. Recent studies, however, have consistently shown that tuition assistance programs tend to attract higher-quality employees who stay on the job longer with that employer.

Large employers are more likely to provide educational assistance. According to academic research, 85 percent of 1,000 surveyed large employers offered some form of tuition assistance. The employers see these programs as both a recruitment tool and a retention tool. More education enables the employees to enjoy upward mobility within the company, and retaining highly trained employees is becoming more important as the baby boomers start to retire and the labor market becomes more competitive.

Source: Adapted from Erin White, "Corporate Tuition Aid Appears to Keep Workers Loyal," *Wall Street Journal*, May 21, 2007, p. B4.

- The value of the use of a gymnasium or other athletic facilities by employees, their spouses, and their dependent children may be excluded from an employee's gross income. The facilities must be on the employer's premises, and substantially all of the use of the facilities must be by employees and their family members.[21]
- Qualified employer-provided educational assistance (tuition, fees, books, and supplies) at the undergraduate and graduate levels is excludible from gross income. The exclusion does not cover meals, lodging, and transportation costs. In addition, it does not cover educational payments for courses involving sports, games, or hobbies. The exclusion is limited to a maximum of $5,250 annually.[22]
- The employee can exclude from gross income up to $12,170 of expenses incurred to adopt a child where the adoption expenses are paid or reimbursed by the employer under a qualified adoption assistance program.[23] The limit on the exclusion is the same even if the child has special needs (is not physically or mentally capable of caring for himself or herself). The exclusion is phased out over the AGI range from $182,520 to $222,520.

CAFETERIA PLANS

Generally, if an employee is offered a choice between cash and some other form of compensation, the employee is deemed to have constructively received the cash even when the noncash option is elected. Thus, the employee has gross income regardless of the option chosen.

An exception to this constructive receipt treatment is provided under the cafeteria plan rules. Under such a plan, the employee is permitted to choose between cash and nontaxable benefits (e.g., group term life insurance, health and accident protection, and child care). If the employee chooses the otherwise nontaxable benefits, the cafeteria plan rules allow the benefits to be excluded from the employee's gross income.[24] **Cafeteria plans** provide tremendous flexibility in tailoring the employee pay package to fit individual needs. Some employees (usually the younger group) prefer cash, while others (usually the older group) will opt for the fringe benefit program. However, long-term care insurance cannot be part of a cafeteria plan. Thus, an employer that wishes to provide long-term care benefits must provide such benefits separate from the cafeteria plan.[25]

[21] § 132(j)(4).
[22] § 127.
[23] § 137.
[24] § 125.
[25] § 125(f).

TAXin the NEWS

Providing a Feel-Good Fringe Benefit at a Low Cost

Employers can provide employees with a variety of fringe benefits that are eligible for exclusion treatment. One such benefit is the adoption expense exclusion (subject to a statutory indexed ceiling amount).

Adoption assistance programs offered by employers to employees enjoy a family-friendly image and are inexpensive to provide from a total labor force perspective. According to Hewitt Associates, a benefits consulting firm, only about 0.1 percent of eligible workers use the exclusion each year. Nevertheless, in the current economic environment, employers are reducing such programs as a way to cut costs. In 2009, employers offering adoption assistance programs fell to 10 percent, down from 22 percent in 2006, according to a survey of 522 employers by the Society for Human Resource Management. General Motors suspended its adoption assistance program five months before filing for bankruptcy.

International adoptions by U.S. parents have fallen 24 percent since 2004, with only 17,438 such adoptions taking place in 2008. At the same time that adoption assistance programs are being cut, costs for international adoptions are increasing and now range between $15,000 and $40,000.

Source: Adapted from Sue Shellenburger, "Targeting 'Feel-Good' Benefits," *Wall Street Journal*, July 8, 2009, p. D1.

Hawk Corporation offers its employees (on a nondiscriminatory basis) a choice of any one or all of the following benefits:

Benefit	Cost
Group term life insurance	$ 200
Hospitalization insurance for family members	2,400
Child care payments	1,800
	$4,400

If a benefit is not selected, the employee receives cash equal to the cost of the benefit.

Kay, an employee, has a spouse who works for another employer that provides hospitalization insurance but no child care payments. Kay elects to receive the group term life insurance, the child care payments, and $2,400 of cash. Only the $2,400 must be included in Kay's gross income. ■

FLEXIBLE SPENDING PLANS

Flexible spending plans (often referred to as flexible benefit plans) operate much like cafeteria plans. Under these plans, the employee accepts lower cash compensation in return for the employer's agreement to pay certain costs that the employer can pay without the employee recognizing gross income. For example, assume the employer's health insurance policy does not cover dental expenses. The employee could estimate his or her dental expenses for the upcoming year and agree to a salary reduction equal to the estimated dental expenses. The employer then pays or reimburses the employee for the actual dental expenses incurred, up to the amount of the salary reduction. If the employee's actual dental expenses are less than the reduction in cash compensation, the employee cannot recover the difference. Hence, these plans are often referred to as *use or lose* plans. As is the case for cafeteria plans, flexible spending plans cannot be used to pay long-term care insurance premiums.

GENERAL CLASSES OF EXCLUDED BENEFITS

An employer can provide a variety of economic benefits to employees. Under the all-inclusive concept of income, the benefits are taxable unless one of the provisions previously discussed specifically excludes the item from gross income. The amount of the income is the fair market value of the benefit. This reasoning can lead to results that Congress considers unacceptable, as illustrated in the following example.

TAX in the NEWS

Employees Lose Some under "Use or Lose Plans"

Over 21 million Americans lose between $125 and $200 every year as a result of overfunding their flexible benefit accounts. If the employee overestimates the amount required to provide the flexible benefits, and thus the reduction in the employee's salary, the unused portion of the fund is forfeited to the employer. The total forfeited amounts exceed $2 billion annually. Thus, employees appear to be substantial losers under these "use-it-or-lose-it" plans. Even though employees can still be net beneficiaries from the portion of the accounts that is actually used, the employees simply are not maximizing the benefits.

Tax legislation has been proposed on several occasions recently to allow any unused amount in a flexible benefit account to be transferred to various types of employee retirement accounts or to otherwise carry over for the employee's benefit. To date, none of these proposals has been enacted.

However, in a recent Notice, the IRS announced that employers can now amend their plans to allow employees a grace period of two and one-half months. That is, the amount set aside in a calendar year plan can be used until March 15 of the following year. Employers will generally amend the plans to provide that payments made before March 15 of the current year be taken first from the beginning-of-the-year balance in the account.

EXAMPLE 14

Vern is employed in New York as a ticket clerk for Trans National Airlines. Vern would like to visit his mother, who lives in Miami, Florida, but he has no money for plane tickets. Trans National has daily flights from New York to Miami that often leave with empty seats. The cost of a round-trip ticket is $500, and Vern is in the 25% tax bracket. If Trans National allows Vern to fly without charge to Miami, under the general gross income rules, Vern has income equal to the value of a ticket. Therefore, Vern must pay $125 tax (.25 × $500) on a trip to Miami. Because Vern does not have $125, he cannot visit his mother, and the airplane flies with another empty seat. ■

If Trans National in Example 14 will allow employees to use resources that would otherwise be wasted, why should the tax laws interfere with the employee's decision to take advantage of the available benefit? Thus, to avoid the economic inefficiency that occurs in Example 14 and in similar situations, as well as to create uniform rules for fringe benefits, Congress established seven broad classes of nontaxable employee benefits:[26]

- No-additional-cost services.
- Qualified employee discounts.
- Working condition fringes.
- *De minimis* fringes.
- Qualified transportation fringes.
- Qualified moving expense reimbursements.
- Qualified retirement planning services.

No-Additional-Cost Services

Example 14 illustrates a no-additional-cost fringe benefit. **No-additional-cost services** are excluded from an employee's gross income if all of the following conditions are satisfied:

- The employee receives services, as opposed to property.
- The employer does not incur substantial additional costs, including forgone revenue, in providing the services to the employee.
- The services must be from the same line of business in which the employee works.
- The services are offered to customers in the ordinary course of the business in which the employee works.[27]

[26]See, generally, § 132.

[27]Reg. § 1.132–2.

Assume that Vern in Example 14 can fly without charge only if the airline cannot fill the seats with paying customers. That is, Vern must fly on standby. Although the airplane may burn slightly more fuel because Vern is aboard and Vern may receive the same meal or snacks as paying customers, the additional costs would not be substantial. Thus, the trip could qualify as a no-additional-cost service.

On the other hand, assume that Vern is given a reserved seat on a flight that is frequently full. The employer would be forgoing revenue to allow Vern to fly. This forgone revenue would be a substantial additional cost, and thus the benefit would be taxable to Vern. ■

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The no-additional-cost exclusion extends to the employee's spouse and dependent children and to retired and disabled former employees. In the Regulations, the IRS has conceded that partners who perform services for the partnership are employees for purposes of the exclusion.[28] However, the exclusion is not extended to highly compensated employees unless the benefit is available on a nondiscriminatory basis.

Qualified Employee Discounts

When the employer sells goods or services (other than no-additional-cost benefits just discussed) to the employee for a price that is less than the price charged regular customers, the employee ordinarily recognizes income equal to the discount. However, **qualified employee discounts** can be excluded from the gross income of the employee, subject to the following conditions and limitations:

- The exclusion is not available for discounted sales of real property (e.g., a house) or for personal property of the type commonly held for investment (e.g., common stocks).
- The property or services must be from the same line of business in which the employee works.
- In the case of property, the exclusion cannot exceed the gross profit component of the price to customers.
- In the case of services, the exclusion is limited to 20 percent of the customer price.[29]

Silver Corporation, which operates a department store, sells a television set to a store employee for $300. The regular customer price is $500, and the gross profit rate is 25%. The corporation also sells the employee a service contract for $100. The regular customer price for the contract is $150. The employee must recognize income of $95, computed as follows:

Customer price for property	$ 500	
Less: Qualifying discount (25% gross profit × $500 price)	(125)	
	$ 375	
Employee price	(300)	
Excess discount recognized as income		$75
Customer price for service	$ 150	
Less: Qualifying discount (20%)	(30)	
	$ 120	
Employee price	(100)	
Excess discount recognized as income		20
Total income recognized		$95

■

[28] Reg. § 1.132–1(b).

[29] § 132(c).

EXAMPLE 17

Assume the same facts as in Example 16, except that the employee is a clerk in a hotel operated by Silver Corporation. Because the line of business requirement is not met, the employee must recognize $200 of income ($500 – $300) from the discount on the television and $50 of income ($150 – $100) from the service contract. ■

As in the case of no-additional-cost benefits, the exclusion applies to employees, their spouses and dependent children, and retired and disabled former employees. However, the exclusion does not extend to highly compensated individuals unless the discount is available on a nondiscriminatory basis.

Working Condition Fringes

Generally, an employee may exclude the cost of property or services provided by the employer if the employee could deduct the cost of those items if he or she had actually paid for them.[30] These benefits are called **working condition fringes**.

EXAMPLE 18

Mitch is a certified public accountant employed by an accounting firm. The employer pays Mitch's annual dues to professional organizations. Mitch is not required to include the payment of the dues in gross income because if he had paid the dues, he would have been allowed to deduct the amount as an employee business expense (as discussed later in this chapter). ■

In many cases, this exclusion merely avoids reporting income and an offsetting deduction. However, in two specific situations, the working condition fringe benefit rules allow an exclusion where the expense would not be deductible if paid by the employee:

- Some automobile salespeople are allowed to exclude the value of certain personal use of company demonstrators (e.g., commuting to and from work).[31]
- The employee business expense would be eliminated by the 2 percent floor on miscellaneous itemized deductions under § 67 (refer to Chapter 16).

Unlike the other fringe benefits discussed previously, working condition fringes can be made available on a discriminatory basis and still qualify for the exclusion.

De Minimis *Fringes*

As the term suggests, ***de minimis* fringe benefits** are so small that accounting for them is impractical.[32] The House Report contains the following examples of *de minimis* fringes:

- The typing of a personal letter by a company secretary, occasional personal use of a company copying machine, occasional company cocktail parties or picnics for employees, occasional supper money or taxi fare for employees because of overtime work, and certain holiday gifts of property with a low fair market value are excluded.
- The value of meals consumed in a subsidized eating facility (e.g., an employees' cafeteria) operated by the employer is excluded if the facility is located on or near the employer's business premises, if revenue equals or exceeds direct operating costs, and if nondiscrimination requirements are met.

When taxpayers venture beyond the specific examples contained in the House Report and the Regulations, there is obviously much room for disagreement as to what is *de minimis*. However, note that except in the case of subsidized eating facilities, *de minimis* fringe benefits can be granted in a manner that favors highly compensated employees.

[30] § 132(d).
[31] § 132(j)(3).
[32] § 132(e).

Qualified Transportation Fringes

The intent of the exclusion for **qualified transportation fringes** is to encourage the use of mass transit for commuting to and from work. Qualified transportation fringes encompass the following transportation benefits provided by the employer to the employee:[33]

1. Transportation in a commuter highway vehicle between the employee's residence and the place of employment.
2. A transit pass.
3. Qualified parking.
4. Qualified bicycle commuting reimbursement.

Statutory dollar limits are placed on the amount of the exclusion. Categories (1) and (2) above are combined for purposes of applying the limit. In this case, the limit on the exclusion for 2009 was originally set at $120 per month. However, ARRTA of 2009 increased this amount to $230 a month (starting in March 2009) and carries it through 2010. Category (3) has a separate limit. For qualified parking, the limit on the exclusion for 2010 is $230 per month. Both of these dollar limits are indexed annually for inflation.

A commuter highway vehicle is any highway vehicle with a seating capacity of at least six adults (excluding the driver). In addition, at least 80 percent of the vehicle's use must be for transporting employees between their residences and place of employment.

Qualified parking includes the following:

- Parking provided to an employee on or near the employer's business premises.
- Parking provided to an employee on or near a location from which the employee commutes to work via mass transit, in a commuter highway vehicle, or in a carpool.

The *qualified bicycle commuting reimbursement* enables an employee to exclude up to $20 per month received from an employer as reimbursement for the cost of commuting by bicycle (i.e., bicycle purchase, improvement, repair, and storage).

Qualified transportation fringes may be provided directly by the employer or may be in the form of cash reimbursements.

EXAMPLE 19

Gray Corporation's offices are located in the center of a large city. The company pays for parking spaces to be used by the company officers. Steve, a vice president, receives $250 of such benefits each month. The parking space rental qualifies as a qualified transportation fringe. Of the $250 benefit received each month by Steve, $230 is excludible from gross income. The balance of $20 is included in his gross income. The same result would occur if Steve paid for the parking and was reimbursed by his employer. ■

Qualified Moving Expense Reimbursements

Qualified moving expenses that are reimbursed or paid by the employer are excludible from gross income. A qualified moving expense is one that would be deductible under § 217. See the discussion of moving expenses later in this chapter.

Qualified Retirement Planning Services

Qualified retirement planning services include any retirement planning advice or information provided by an employer who maintains a qualified retirement plan to an employee or the spouse.[34] Congress decided to exclude the value of such services from gross income because they are a key part of retirement income planning. Such an exclusion should motivate more employers to provide retirement planning services to their employees.

Nondiscrimination Provisions

For no-additional-cost services, qualified employee discounts, and qualified retirement planning services, if the plan is discriminatory in favor of *highly compensated employees*,[35]

[33] § 132(f).

[34] §§ 132(a)(7) and (m).

[35] See § 414(q) for the definition of highly compensated employee.

these key employees are denied exclusion treatment. However, any non-highly compensated employees who receive these benefits can still enjoy exclusion treatment.[36]

EXAMPLE 15

Dove Company's officers are allowed to purchase goods from the company at a 25% discount. Other employees are allowed only a 15% discount. The company's gross profit margin on these goods is 30%.

Peggy, an officer in the company, purchased goods from the company for $750 when the price charged to customers was $1,000. Peggy must include $250 in gross income because the plan is discriminatory.

Leo, an employee of the company who is not an officer, purchased goods for $850 when the customer price was $1,000. Leo is not required to recognize gross income because he received a qualified employee discount. ■

De minimis fringe benefits (except for subsidized eating facilities) and working condition fringe benefits can be provided on a discriminatory basis. Likewise, the qualified transportation fringe and the qualified moving expense reimbursement can be provided on a discriminatory basis.

DIGGING DEEPER 5

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

TAXABLE FRINGE BENEFITS

If fringe benefits cannot qualify for any of the specific exclusions or do not fit into any of the general classes of excluded benefits, the employee must recognize gross income equal to the fair market value of the benefits received. Obviously, problems are frequently encountered in determining values. To help taxpayers cope with these problems, the IRS has issued extensive Regulations addressing the valuation of personal use of an employer's automobiles and meals provided at an employer-operated eating facility.[37]

If a fringe benefit plan discriminates in favor of highly compensated employees, generally those employees are not allowed to exclude the benefits they receive that other employees do not enjoy. However, the highly compensated employees, as well as the other employees, are generally allowed to exclude the nondiscriminatory benefits.[38]

EXAMPLE 16

MED Company has a medical reimbursement plan that reimburses officers for 100% of their medical expenses, but reimburses all other employees for only 80% of their medical expenses. Cliff, the president of the company, was reimbursed $1,000 during the year for medical expenses. Cliff must include $200 in gross income [(1 − .80) × $1,000 = $200]. Mike, an employee who is not an officer, received $800 (80% of his actual medical expenses) under the medical reimbursement plan. None of the $800 is includible in his gross income. ■

FOREIGN EARNED INCOME

A U.S. citizen is generally subject to U.S. tax on his or her income regardless of the income's geographic origin. The income may also be subject to tax in the foreign country, and thus the taxpayer would carry a double tax burden. Out of a sense of fairness and to encourage U.S. citizens to work abroad (so that exports might be increased), Congress has provided alternative forms of relief from taxes on foreign earned income. The taxpayer can elect *either* (1) to include the foreign income in

[36] §§ 61, 132(j)(1), and 132(m)(2).

[37] Reg. § 1.61–2T(j). Generally, the income from the personal use of the employer's automobile is based on the lease value of the automobile (what it would have cost the employee to lease the automobile). Meals are valued at 150% of the employer's direct costs (e.g., food and labor) of preparing the meals.

[38] §§ 79(d), 105(h), 127(b)(2), and 132(j)(1).

his or her taxable income and then claim a credit for foreign taxes paid or (2) to exclude the foreign earnings from his or her U.S. gross income (the **foreign earned income exclusion**).[39] The foreign tax credit option is discussed in Chapter 14, but as is apparent from the following discussion, most taxpayers will choose the exclusion.

Foreign earned income consists of the earnings from the individual's personal services rendered in a foreign country (other than as an employee of the U.S. government). To qualify for the exclusion, the taxpayer must be either of the following:

- A bona fide resident of the foreign country (or countries).
- Present in a foreign country (or countries) for at least 330 days during any 12 consecutive months.

Sandra's trips to and from a foreign country in connection with her work were as follows:

Arrived in Foreign Country	Arrived in United States
March 10, 2009	February 1, 2010
March 7, 2010	June 1, 2010

During the 12 consecutive months ending on March 10, 2010, Sandra was present in the foreign country for at least 330 days (365 days less 28 days in February and 7 days in March 2010). Therefore, all income earned in the foreign country through March 10, 2010, is eligible for the exclusion. The income earned from March 11, 2010, through May 31, 2010, is also eligible for the exclusion because Sandra was present in the foreign country for 330 days during the 12 consecutive months ending on May 31, 2010. ■

The exclusion is *limited* to an indexed amount of $91,500 for 2010 ($91,400 in 2009). For married persons, both of whom have foreign earned income, the exclusion is computed separately for each spouse. Community property rules do not apply (the community property spouse is not deemed to have earned one-half of the other spouse's foreign earned income). If all the days in the tax year are not qualifying days, then the taxpayer must compute the maximum exclusion on a daily basis ($91,500 divided by the number of days in the entire year and multiplied by the number of qualifying days).

Keith qualifies for the foreign earned income exclusion. He was present in France for all of 2010. Keith's salary for 2010 is $100,000. Since all of the days in 2010 are qualifying days, Keith can exclude $91,500 of his $100,000 salary.

Assume instead that only 335 days were qualifying days. Then, Keith's exclusion is limited to $83,980, computed as follows:

$$\$91{,}500 \times \frac{335 \text{ days in foreign country}}{365 \text{ days in the year}} = \$83{,}980$$ ■

17.3 Employee Expenses

LO.3

Apply the rules for computing deductible expenses of employees including transportation, travel, moving, education, and entertainment expenses.

Once the employment relationship is established, employee expenses fall into one of the following categories:

- Transportation.
- Travel.
- Moving.
- Education.
- Entertainment.
- Other.

[39] §911.



CONCEPT SUMMARY 17.1

General Classes of Fringe Benefits

Benefit	Description and Examples	Coverage Allowed	Effect of Discrimination
1. No-additional-cost services	The employee takes advantage of the employer's excess capacity (e.g., free passes for airline employees).	Current, retired, and disabled employees; their spouses and dependent children; spouses of deceased employees. Partners are treated as employees.	No exclusion for highly compensated employees.
2. Qualified discounts on goods	The employee is allowed a discount no greater than the gross profit margin on goods sold to customers.	Same as (1) above.	Same as (1) above.
3. Qualified discounts on services	The employee is allowed a discount (maximum of 20%) on services the employer offers to customers.	Same as (1) above.	Same as (1) above.
4. Working condition fringes	Expenses paid by the employer that would be deductible if paid by the employee (e.g., a mechanic's tools). Also, includes auto salesperson's use of a car held for sale.	Current employees, partners, directors, and independent contractors.	No effect.
5. *De minimis* items	Expenses so immaterial that accounting for them is not warranted (e.g., occasional supper money, personal use of the copy machine).	*Any recipient* of a fringe benefit.	No effect.
6. Qualified transportation fringes	Transportation benefits provided by the employer to employees, including commuting in a commuter highway vehicle, a transit pass, qualified parking, and qualified bicycle commuting.	Current employees.	No effect.
7. Qualified moving expense reimbursements	Qualified moving expenses that are paid or reimbursed by the employer. A qualified moving expense is one that would be deductible under § 217.	Current employees.	No effect.
8. Qualified retirement planning services	Qualified retirement planning services that are provided by the employer.	Current employees and spouses.	Same as (1) above.

These expenses are discussed below in the order presented. Keep in mind, however, that these expenses are not necessarily limited to employees. A deduction for business transportation, for example, is equally available to taxpayers who are self-employed.

TRANSPORTATION EXPENSES

Qualified Expenditures

An employee may deduct unreimbursed employment-related **transportation expenses** as an itemized deduction *from* AGI. Transportation expenses include only the cost of transporting the employee from one place to another when the employee is not away from home in travel status. Such costs include taxi fares, automobile expenses, tolls, and parking.

Commuting Expenses

Commuting between home and one's place of employment is a personal, nondeductible expense. The fact that one employee drives 30 miles to work and another employee walks six blocks is of no significance.[40]

Geraldo is employed by Sparrow Corporation. He drives 22 miles each way to work. The 44 miles he drives each workday are nondeductible commuting expenses. ■

The expenses of getting from one job to another job or from one work station to another work station are deductible transportation expenses rather than nondeductible commuting expenses.

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.



In the current year, Cynthia holds two jobs, a full-time job with Blue Corporation and a part-time job with Wren Corporation. During the 250 days that she works (adjusted for weekends, vacation, and holidays), Cynthia customarily leaves home at 7:30 A.M. and drives 30 miles to the Blue Corporation plant, where she works until 5:00 P.M. After dinner at a nearby café, Cynthia drives 20 miles to Wren Corporation and works from 7:00 to 11:00 P.M. The distance from the second job to Cynthia's home is 40 miles. Her deduction is based on 20 miles (the distance between jobs). ■

Computation of Automobile Expenses

A taxpayer has two choices in computing deductible automobile expenses. The actual operating cost, which includes depreciation (refer to Chapter 5), gas, oil, repairs, licenses, and insurance, may be used. Records must be kept that detail the automobile's personal and business use. Only the percentage allocable to business transportation and travel is allowed as a deduction.

Use of the **automatic mileage method** is the second alternative. For 2010, the deduction is based on 50 cents per mile for business miles.[41] Parking fees and tolls are allowed in addition to expenses computed using the automatic mileage method.

Generally, a taxpayer may elect either method for any particular year. However, the following restrictions apply:

- The vehicle must be owned or leased by the taxpayer.
- If five or more vehicles are in use (for business purposes) at the *same* time (not alternately), a taxpayer may not use the automatic mileage method.
- Use of the automatic mileage method in the first year the auto is placed in service is considered an election not to use the MACRS method of depreciation (refer to Chapter 5).
- A taxpayer may not switch to the automatic mileage method if the MACRS statutory percentage method or the election to expense under § 179 has been used.

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.



[40] *Tauferner v. U.S.*, 69–1 USTC ¶9241, 23 AFTR 2d 69–1025, 407 F.2d 243 (CA–10, 1969).

[41] Rev.Proc. 2009–54, I.R.B. No. 51, 930. For all of 2009, the business mileage rate was 55 cents. In some past years, however, the rate set did not remain the same for the entire year. Due to sizable fluctuations in fuel prices, a different rate was set for the last part of the year. The possibility of such a change makes it important that the taxpayer be able to identify when the mileage took place.

TAX in the NEWS

Turning a Saturday Leisure Day into a Business Day

The high cost of air travel together with the substantial discount allowed for a Saturday night stayover may offer travelers an opportunity to do some sightseeing or shopping on business trips. The extra meals and lodging expenses for the nonbusiness day are deductible if the cost is less than the additional cost of flying without a Saturday stay. For the employee, any reimbursement for such costs is nontaxable. Thus, the Saturday is treated as a business day even though no business activity takes place.

TRAVEL EXPENSES

Definition of Travel Expenses

An itemized deduction is allowed for *unreimbursed* **travel expenses** related to a taxpayer's employment. Travel expenses are more broadly defined in the Code than are transportation expenses. Travel expenses include transportation expenses and meals and lodging while away from home in the pursuit of a trade or business. Meals cannot be lavish or extravagant. A deduction for meals and lodging is available only if the taxpayer is away from his or her tax home. Deductible travel expenses also include reasonable laundry and incidental expenses.

DIGGING DEEPER 8

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

Away-from-Home Requirement

The crucial test for the deductibility of travel expenses is whether the employee is away from home overnight. "Overnight" need not be a 24-hour period, but it must be a period substantially longer than an ordinary day's work and must require rest, sleep, or a relief-from-work period.[42] A one-day business trip is not travel status, and meals and lodging for such a trip are not deductible.

Temporary Assignments

The employee must be away from home for a temporary period. If the taxpayer-employee is reassigned to a new post for an indefinite period of time, that new post becomes his or her tax home. Temporary indicates that the assignment's termination is expected within a reasonably short period of time. The position of the IRS is that the tax home is the business location, post, or station of the taxpayer. Thus, travel expenses are not deductible if a taxpayer is reassigned for an indefinite period and does not move his or her place of residence to the new location.

EXAMPLE 10

Malcolm's employer opened a branch office in San Diego. Malcolm was assigned to the new office for three months to train a new manager and to assist in setting up the new office. He tried commuting from his home in Los Angeles for a week and decided that he could not continue driving several hours a day. He rented an apartment in San Diego, where he lived during the week. He spent weekends with his wife and children at their home in Los Angeles. Malcolm's rent, meals, laundry, incidentals, and automobile expenses in San Diego are deductible. To the extent that Malcolm's transportation expense related to his weekend trips home exceeds what his cost of meals and lodging would have been, the excess is personal and nondeductible. ■

[42] *U.S. v. Correll*, 68–1 USTC ¶9101, 20 AFTR 2d 5845, 88 S.Ct 445 (USSC, 1967); Rev.Rul. 75–168, 1975–1 C.B. 58.

TAX in the NEWS

Relief for Members of the Armed Forces Reserves

In the Military Family Tax Relief Act of 2003, Congress provided various tax benefits for reservists, one of which deals with the classification of travel expenses. Members of the Reserves or National Guard who travel to drills and other service-related activities may claim the expenses as deductions *for* AGI. Previously, the expenses were not deductible unless the taxpayer itemized. (As miscellaneous itemized deductions, they were subject to the 2 percent-of-AGI floor.) To qualify for the deduction *for* AGI classification, the trip must be more than 100 miles from home and include an overnight stay. Any deduction is limited to the Federal per diem rates applicable to the area involved.

Assume that Malcolm in Example 26 was transferred to the new location to become the new manager permanently. His wife and children continued to live in Los Angeles until the end of the school year. Malcolm is no longer "away from home" because the assignment is not temporary. His travel expenses are not deductible. ■

To curtail controversy in this area, the Code specifies that a taxpayer "shall not be treated as temporarily away from home during any period of employment if such period exceeds 1 year."[43]

Determining the Tax Home

Under ordinary circumstances, determining the location of a taxpayer's tax home does not present a problem. The tax home is the area in which the taxpayer derives his or her principal source of income; when the taxpayer has more than one place of employment, the tax home is based on the amount of time spent in each area.

It is possible for a taxpayer never to be away from his or her tax home. In other words, the tax home follows the taxpayer.[44] Under such circumstances, all meals and lodging remain personal and are not deductible.

Bill is employed as a long-haul truck driver. He is single, stores his clothes and other belongings at his parents' home, and stops there for periodic visits. Most of the time, Bill is on the road, sleeping in his truck and in motels. It is likely that Bill is never in travel status, as he is not away from home. Consequently, none of his meals and lodging are deductible. ■

Combined Business and Pleasure Travel

To be deductible, travel expenses need not be incurred in the performance of specific job functions. Travel expenses incurred to attend a professional convention are deductible by an employee if attendance is connected with services as an employee. For example, an employee of a law firm can deduct travel expenses incurred to attend a meeting of the American Bar Association.

Travel deductions have been used in the past by persons who claimed a tax deduction for what was essentially a personal vacation. As a result, several provisions have been enacted to restrict deductions associated with combined business and pleasure trips. If the business/pleasure trip is from one point in the United States to another point in the United States (*domestic travel*), the transportation expenses are deductible only if the trip is primarily for business.[45] If the trip is primarily for pleasure, no transportation expenses qualify as a deduction. Meals, lodging, and other expenses are allocated between business and personal days.

[43] § 162(a).

[44] *Moses Mitnick*, 13 T.C. 1 (1949).

[45] Reg. § 1.162–2(b)(1).



In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

EXAMPLE 29

In the current year, Hana travels from Seattle to New York primarily for business. She spends five days conducting business and three days sightseeing and attending shows. Her plane and taxi fare amounts to $560. Her meals amount to $100 per day, and lodging and incidental expenses are $150 per day. She can deduct the transportation expenses of $560, since the trip is primarily for business (five days of business versus three days of sightseeing). Deductible meals are limited to five days and are subject to the 50% cutback (discussed later in the chapter) for a total of $250 [5 days × ($100 × 50%)], and other deductions are limited to $750 (5 days × $150). If Hana is an employee, the unreimbursed travel expenses are miscellaneous itemized deductions subject to the 2%-of-AGI floor. ■

When the trip is outside the United States (*foreign travel*), special rules apply.[46] Transportation expenses must be allocated between business and personal days *unless* (1) the taxpayer is away from home for seven days or less or (2) less than 25 percent of the time was for personal purposes. No allocation is required if the taxpayer has no substantial control over arrangements for the trip or the desire for a vacation is not a major factor in taking the trip. If the trip is primarily for pleasure, no transportation charges are deductible. Days devoted to travel are considered business days. Weekends, legal holidays, and intervening days are considered business days, provided that both the preceding and succeeding days were business days.



In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

EXAMPLE 30

In the current year, Robert takes a trip from New York to Japan primarily for business purposes. He is away from home from June 10 through June 19. He spends three days vacationing and seven days conducting business (including two travel days). His airfare is $2,500, his meals amount to $100 per day, and lodging and incidental expenses are $160 per day. Since Robert is away from home for more than seven days and more than 25% of his time is devoted to personal purposes, only 70% (7 days business/10 days total) of the transportation is deductible. His deductions are as follows:

Transportation (70% × $2,500)		$1,750
Lodging ($160 × 7)		1,120
Meals ($100 × 7)	$ 700	
Less: 50% cutback (discussed later in this chapter)	(350)	350
Total deductions		$3,220

If Robert is gone the same period of time but spends only two days (less than 25% of the total) vacationing, no allocation of transportation is required. Since the pleasure portion of the trip is less than 25% of the total, all of the airfare qualifies for the travel deduction. ■

The foreign convention rules do not operate to bar a deduction to an employer if the expense is *compensatory* in nature. For example, a trip to Rome won by a top salesperson is included in the gross income of the employee and is fully deductible by the employer.

[46] § 274(c) and Reg. § 1.274–4. For purposes of the seven-days-or-less exception, the departure travel day is not counted.

Tax Planning Strategies TRANSPORTATION AND TRAVEL EXPENSES

FRAMEWORK FOCUS: DEDUCTIONS

Strategy: Maximize Deductible Amounts.

Adequate detailed records of all transportation and travel expenses should be kept. Since the regular mileage allowance often is modest in amount, a new, expensive automobile used primarily for business may generate a higher expense based on actual cost. The election to expense part of the cost of the automobile under § 179, MACRS depreciation, insurance, repairs and maintenance, automobile club dues, and other related costs may result in automobile expenses greater than the automatic mileage allowance.

If a taxpayer wishes to sightsee or vacation on a business trip, it would be beneficial to schedule business on both a Friday and a Monday to turn the weekend into business days for allocation purposes. It is especially crucial to schedule appropriate business days when foreign travel is involved.

MOVING EXPENSES

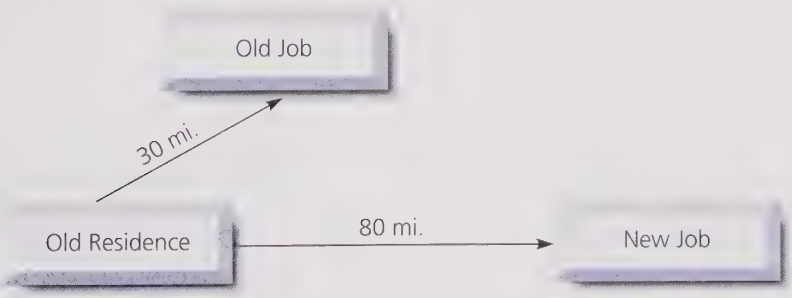
Moving expenses are deductible for moves in connection with the commencement of work at a new principal place of work.[47] Both employees and self-employed individuals can deduct these expenses. To be eligible for a moving expense deduction, a taxpayer must meet two basic tests: distance and time.

Distance Test

To meet the distance test, the taxpayer's new job location must be at least 50 miles farther from the taxpayer's old residence than the old residence was from the former place of employment. In this regard, the location of the new residence is not relevant. This eliminates a moving expense deduction for (1) taxpayers who purchase a new home in the same general area without changing their place of employment and (2) taxpayers who accept a new job in the same area as their old job.

EXAMPLE 31

Harry is permanently transferred to a new job location. The distance from Harry's former home to his new job (80 miles) exceeds the distance from his former home to his old job (30 miles) by at least 50 miles. Harry has met the distance test for a moving expense deduction.



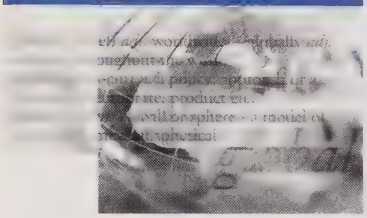
If Harry is not employed before the move, his new job must be at least 50 miles from his former residence. In this instance, Harry has also met the distance test if he was not previously employed. ■

Time Test

To meet the time test, an employee must be employed on a full-time basis at the new location for 39 weeks in the 12-month period following the move. If the taxpayer is a self-employed individual, he or she must work in the new location for 78 weeks

[47] § 217(a).

GLOBAL *Tax Issues*



Expatriates and the Moving Expense Deduction

Expatriates, U.S. persons who accept work assignments overseas, enjoy several favorable tax advantages regarding foreign moves. First, the cost of storing household goods qualifies as a moving expense. This could lead to a major tax saving since expatriates do not ship most of their household effects to the foreign location. Furthermore, the cost of storage, particularly in a climate-controlled facility, is not insignificant.

The second advantage expatriates may enjoy is an exemption from the time test. Those who return to the United States to retire are absolved from the 39-week or 78-week work requirement. Thus, the return home expenses are treated as qualified moving expenses.

during the two years following the move. The first 39 weeks must be in the first 12 months. The time test is disregarded if the taxpayer dies, becomes disabled, or is discharged (other than for willful misconduct) or transferred by the new employer.

DIGGING DEEPER 11

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

Treatment of Moving Expenses

Qualified moving expenses include reasonable expenses of:

- Moving household goods and personal effects.
- Traveling from the former residence to the new place of residence.

For this purpose, traveling includes lodging, but not meals, for the taxpayer and members of the household.[48] It does not include the cost of moving servants or others who are not members of the household. The taxpayer can elect to use actual auto expenses (no depreciation is allowed) or the automatic mileage method. In this case, moving expense mileage is limited in 2010 to 16.5 cents per mile for each car. The automatic mileage rate for 2009 was 24 cents per mile. These expenses are also limited by the reasonableness standard. For example, if one moves from Texas to Florida via Maine and takes six weeks to do so, the transportation and lodging must be allocated between personal and moving expenses.

EXAMPLE 15

Jill is transferred by her employer from the Atlanta office to the San Francisco office. In this connection, she spends the following amounts:

Cost of moving furniture	$6,800
Transportation	700
Meals	400
Lodging	900

Jill's total qualified moving expense is $8,400 ($6,800 + $700 + $900). ■

The moving expense deduction is allowed regardless of whether the employee is transferred by the existing employer or is employed by a new employer. It is allowed if the employee moves to a new area and obtains employment or switches from self-employed status to employee status (and vice versa). The moving expense deduction is also allowed if an individual is unemployed before obtaining employment in a new area.

[48] § 217(b).

TAX in the NEWS

Even the Smithsonian Can't Get It Right

Somewhat concerned about the way it was handling the moving expenses of new employees and existing employees who were relocated, the Smithsonian Institution underwent an audit by its Inspector General Division. The results of the audit revealed weak controls and inconsistent practices. Many of the payments were made to third-party providers of services (e.g., hotels, restaurants) while other payments were direct reimbursements to employees. Expenses reimbursed included temporary living expenses, closing costs on the purchase of a new home, and tuition deposits for the children of new hires—all of which are clearly income to the recipients. Whether such reimbursements were ever subject to income tax is problematical, as some ($200,000 out of $1.4 million) were never included in the W–2 forms issued to the employees involved.

After learning of the audit results, the Smithsonian announced that it would establish new payroll procedures to correct the problems. Until this is done, any such disbursements will be labeled and reported as "recruitment payments."

When a prestigious organization like the Smithsonian is having difficulty properly accounting for the treatment of moving expense reimbursements, one has to wonder how prevalent the problem might be. For example, how many nonqualifying reimbursements escape income recognition because they are misclassified (or not reported) by the employer—either deliberately or inadvertently.

Source: Audit Report of the Office of Inspector General of the Smithsonian Institution, *Administration of Relocation and Recruitment Payments*, September 28, 2007.

What Is Not Included

In addition to meals while en route, the moving expense deduction does *not* include the following costs:

- New car tags and driver's licenses.
- Loss on the sale of a residence or penalty for breaking a lease.
- Forfeiture of security deposits and loss from disposing of club memberships.
- Pre-move house-hunting expenses.
- Temporary living expenses.

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

12 DIGGING DEEPER

Tax Planning Strategies Moving Expenses

FRAMEWORK FOCUS: DEDUCTIONS

Strategy: Maximize Deductible Amounts.

Persons who retire and move to a new location incur personal nondeductible moving expenses. If the retired person accepts a full-time job in the new location before moving and meets the time and distance requirements, the moving expenses are deductible.

EXAMPLE 31

At the time of his retirement from the national office of a major accounting firm, Gordon had an annual salary of $480,000. He moves from New York City to Seattle to retire, and accepts a full-time teaching position at a Seattle junior college at an annual salary of $22,000. If Gordon satisfies the 39-week test, his moving expenses are deductible. The disparity between the two salaries (previous and current) is of no consequence. ■

TAX in the NEWS

Is an MBA Degree Deductible?

Education that maintains or improves existing skills is deductible, but education that qualifies a taxpayer for a new field is not. But how do these basic rules apply to a conventional (i.e., nonspecialized) MBA degree? Does being a manager or a consultant require an MBA degree? Generally, the answer has always been that it does not. In this regard, therefore, the education does not create a new skill, so its cost should be deductible.

Several recent holdings, however, have found that an MBA degree can lead to qualifying for a new trade or business. But these holdings involved situations where the education resulted in a job change and satisfied different minimum requirements set by the employer. In one case, for example, the taxpayer moved from the position of investment analyst to become an investment banker, and the latter position required an MBA degree. Under these circumstances, the cost of the education was held to be nondeductible.

But barring a change to a job where the degree is required, the cost of an MBA degree should be deductible as merely improving existing managerial skills.

EDUCATION EXPENSES

General Requirements

Employees *and* self-employed individuals can deduct expenses incurred for education as ordinary and necessary business expenses, provided the expenses are incurred to maintain or improve existing skills required in the present job. An employee can also deduct expenses incurred to meet the express requirements of the employer or the requirements imposed by law to retain his or her employment status.

Education expenses are not deductible if the education is for either of the following purposes (except as discussed below under A Limited Deduction Approach):

- To meet the minimum educational standards for qualification in the taxpayer's existing job.
- To qualify the taxpayer for a new trade or business.[49]

Thus, fees incurred for professional exams (the bar exam, for example) and fees for review courses (such as a CPA review course) are not deductible.[50] If the education incidentally results in a promotion or raise, the deduction still can be taken as long as the education maintained and improved existing skills and did not qualify the person for a new trade or business. A change in duties is not always fatal to the deduction if the new duties involve the same general work. For example, the IRS has ruled that a practicing dentist's education expenses incurred to become an orthodontist are deductible.[51]

Requirements Imposed by Law or by the Employer for Retention of Employment

Taxpayers are permitted to deduct education expenses if additional courses are required by the employer or are imposed by law. Many states require a minimum of a bachelor's degree and a specified number of additional courses to retain a teaching job. In addition, some public school systems have imposed a master's degree requirement and require teachers to make satisfactory progress toward a master's degree in order to keep their positions. If the required education is the minimum degree required for the job, no deduction is allowed.

Professionals (such as physicians, attorneys, and CPAs) may deduct expenses incurred to meet continuing professional education requirements imposed by states as a condition for retaining a license to practice.

[49]Reg. §§ 1.162–5(b)(2) and (3).
[50]Reg. § 1.212–1(f) and Rev.Rul. 69–292, 1969–1 C.B. 84.
[51]Rev.Rul. 74–78, 1974–1 C.B. 44.

In order to meet continuing professional education requirements imposed by the State Board of Public Accountancy for maintaining her CPA license, Nancy takes an auditing course sponsored by a local college. The cost of the education is deductible. ■

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft.**



Maintaining or Improving Existing Skills

The *maintaining or improving existing skills* requirement in the Code has been difficult for both taxpayers and the courts to interpret. For example, a business executive is permitted to deduct the costs of obtaining an MBA on the grounds that the advanced management education is undertaken to maintain and improve existing management skills. The executive is eligible to deduct the costs of specialized, nondegree management courses that are taken for continuing education or to maintain or improve existing skills. Expenses incurred by the executive to obtain a law degree are not deductible, however, because the education constitutes training for a new trade or business. The Regulations deny a self-employed accountant a deduction for expenses relating to law school.[52]

Tax Planning Strategies EDUCATION EXPENSES

FRAMEWORK FOCUS: DEDUCTIONS

Strategy: Maximize Deductible Amounts.

Education expenses are treated as nondeductible personal items unless the individual is employed or is engaged in a trade or business. A temporary leave of absence for further education is one way to assure that the taxpayer is still treated as being engaged in a trade or business. An individual was permitted to deduct education expenses even though he resigned from his job, returned to school full-time for two years, and accepted another job in the same field upon graduation. The court held that the student had merely suspended active participation in his field.[53]

If the time out of the field is too long, education expense deductions will be disallowed. For example, a teacher who left the field for four years to raise her child and curtailed her employment searches and writing activities was denied a deduction for education expenses. She was no longer actively engaged in the trade or business of being an educator.[54]

To secure the deduction, an individual should arrange his or her work situation to preserve employee or business status.

As discussed below under *A Limited Deduction Approach*, a limited exception is available for taxpayers who do not meet the above requirements.

Classification of Specific Items

Education expenses include books, tuition, typing, transportation (e.g., from the office to night school), and travel (e.g., meals and lodging while away from home at summer school).

Bill, who holds a bachelor of education degree, is a secondary education teacher in the Los Angeles school system. The school board recently raised its minimum education requirement for new teachers from four years of college training to five. A grandfather clause allows teachers with only four years of college to continue to qualify if they show satisfactory progress toward a graduate degree. Bill enrolls at the University of

[52] Reg. § 1.162–5(b)(3)(ii) Example (1).

[53] *Stephen G. Sherman*, 36 TCM 1191, T.C.Memo. 1977–301.

[54] *Brian C. Mulherin*, 42 TCM 834, T.C.Memo. 1981–454; *George A. Baist*, 56 TCM 778, T.C.Memo. 1988–554.

TABLE 17.2 Limitations for Qualified Tuition Deduction

Filing Status	MAGI Limit	Maximum Deduction Allowed
Single	$ 65,000	$4,000
Married	130,000	
Single	65,001 to 80,000*	2,000
Married	130,001 to 160,000*	2,000

*No deduction is available if MAGI exceeds this amount.

Washington during the summer and takes three graduate courses. His unreimbursed expenses for this purpose are as follows:

Books and tuition	$2,600
Lodging while in travel status (June–August)	1,150
Meals while in travel status	800
Laundry while in travel status	220
Transportation	600

Bill has an itemized deduction as follows:

Books and tuition	$2,600
Lodging	1,150
Meals less 50% cutback (discussed later in this chapter)	400
Laundry	220
Transportation	600
	$4,970

■

A LIMITED DEDUCTION APPROACH

One of the major shortcomings of the education deduction, previously discussed, is that it is unavailable for taxpayers obtaining a basic skill. Thus, a taxpayer working for an accounting firm cannot deduct the cost of earning a bachelor in accounting degree. Under 2001 tax legislation, this shortcoming has been partly resolved with the **deduction for qualified tuition and related expenses**.

A deduction *for* AGI is allowed for qualified tuition and related expenses involving higher education (i.e., postsecondary). The deduction is the lesser of the qualifying amount spent or the maximum amount allowed by § 222. The maximum deductions allowed are shown in Table 17.2. Note that the limitations are based on the taxpayer's MAGI and filing status.[55] Although a phaseout is provided for, note its short and drastic effect. Only two steps are involved ($65,000/$80,000 for single and $130,000/$160,000 for married), and the benefit of § 222 *disappears completely* after the second step. Thus, a married couple with MAGI of $160,000 would lose the entire deduction if they earned an additional $1. The § 222 limitations are not indexed for inflation.

[55]MAGI is modified adjusted gross income as defined in § 222(b)(2). Examples of some of these modifications include the adding back to regular AGI of the foreign earned income exclusion and the domestic production activities deduction. This provision is scheduled to expire at the end of 2009, but is likely to be extended.

Various aspects of the higher education tuition deduction are summarized below:

- Qualified tuition and related expenses include whatever is required for enrollment at the institution. Usually, student activity fees, books, and room and board are not included.[56]
- The expense need not be employment related, although it can be.
- The deduction is available for a taxpayer's spouse or anyone who can be claimed as a dependent and is an eligible student.
- The deduction is not available for married persons who file separate returns.[57]
- To avoid a "double benefit," the deduction must be coordinated with other education provisions (e.g., American Opportunity and lifetime learning credits). Along this same line, no deduction is allowed for a taxpayer who qualifies as another's dependent.[58]
- The deduction *for* AGI classification avoids the 2 percent-of-AGI floor on miscellaneous itemized deductions. See Chapter 16.[59]

EXAMPLE 15

Tina is single and a full-time employee of a CPA firm. During the current year, she attends law school at night and incurs the following expenses: $4,200 for tuition and $340 for books and supplies. Presuming she satisfies the MAGI limitation (see Table 17.2), she can claim $4,000 as a deduction *for* AGI. If she itemizes her deductions for the year, can she claim the $540 not allowed under § 222 ($200 tuition in excess of $4,000 + $340 for books and supplies) as an education expense eligible for itemized deduction treatment? No, because obtaining a law degree leads to a new trade or business. ■

The deduction for qualified tuition and related expenses can be determined by completing Form 8917 (Tuition and Fees Deduction). The form should be attached to Form 1040 (or Form 1040A).

Another deduction item relating to education is the limited deduction of interest on student loans, which is covered in Chapter 16.[60]

ENTERTAINMENT EXPENSES

Many taxpayers attempt to deduct personal **entertainment expenses** as business expenses. For this reason, the tax law restricts the deductibility of entertainment expenses. The Code contains strict record-keeping requirements and provides restrictive tests for the deduction of certain types of entertainment expenses.

The Fifty Percent Cutback

Only 50 percent of meal and entertainment expenses is deductible.[61] The limitation applies to employees, employers, and self-employed individuals. Although the 50 percent cutback can apply to either the employer or the employee, it will not apply twice. The cutback applies to the one who really pays (economically) for the meals or entertainment.

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

14 DIGGING DEEPER

EXAMPLE 16

Jane, an employee of Pelican Corporation, entertains one of her clients. If Pelican Corporation does not reimburse Jane, she is subject to the cutback. If, however, Pelican Corporation reimburses Jane (or pays for the entertainment directly), Pelican suffers the cutback. ■

[56] § 222(d)(1).
[57] § 222(d)(4).
[58] § 222(c).
[59] §§ 61(a)(18) and 67.
[60] § 221.
[61] § 274(n).

Transportation expenses are not affected by the cutback rule—only meals and entertainment expenses are reduced. The cutback also applies to taxes and tips relating to meals and entertainment. Cover charges, parking fees at an entertainment location, and room rental fees for a meal or cocktail party are also subject to the 50 percent cutback.



In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

EXAMPLE 30

Joe pays a $30 cab fare to meet his client for dinner. The meal costs $120, and Joe leaves a $20 tip. His deduction is $100 [($120 + $20) × 50% + $30 cab fare]. ■

Classification of Expenses

Entertainment expenses are classified either as *directly related* to business or *associated with* business.[62] Directly related expenses are related to an actual business meeting or discussion. These expenses are distinguished from entertainment expenses that are incurred to promote goodwill, such as maintaining existing customer relations. To obtain a deduction for directly related entertainment, it is not necessary to show that actual benefit resulted from the expenditure as long as there was a reasonable expectation of benefit. To qualify as directly related, the expense should be incurred in a business setting. If there is little possibility of engaging in the active conduct of a trade or business due to the nature of the social facility, it is difficult to qualify the expenditure as directly related to business.

Expenses associated with, rather than directly related to, business entertainment must serve a specific business purpose, such as obtaining new business or continuing existing business. These expenditures qualify only if the expenses directly precede or follow a bona fide business discussion. Entertainment occurring on the same day as the business discussion is considered associated with business.

EXAMPLE 31

Jerry, a manufacturers' representative, took his client to play a round of golf during the afternoon. They had dinner the same evening, during which time business was discussed. After dinner, they went to a nightclub to have drinks and listen to a jazz band. The business dinner qualifies as directly related entertainment. The golf outing and the visit to the nightclub qualify as associated with entertainment. ■

Tax Planning Strategies ENTERTAINMENT EXPENSES

FRAMEWORK FOCUS: DEDUCTIONS

Strategy: Maximize Deductible Amounts.

Taxpayers should maintain detailed records of amounts, time, place, business purpose, and business relationships. A credit card receipt details the place, date, and amount of the expense. A notation made on the receipt of the names of the person(s) attending, the business relationship, and the topic of discussion should constitute sufficient documentation.[63] Failure to provide sufficient documentation could lead to disallowance of entertainment expense deductions.

Associated with or goodwill entertainment requires a business discussion to be conducted immediately before or after the entertainment. Furthermore, a business purpose must exist for the entertainment. Taxpayers should arrange for a business discussion before or after such entertainment. They also must document the business purpose, such as obtaining new business from a prospective customer.

[62] § 274(a)(1)(A).

[63] *Kenneth W. Guenther*, 54 TCM 382, T.C.Memo. 1987–440.

Restrictions upon Deductibility of Business Meals

Business meals are deductible only if:[64]

- the meal is directly related to or associated with the active conduct of a trade or business,
- the expense is not lavish or extravagant under the circumstances, and
- the taxpayer (or an employee) is present at the meal.

A business meal with a business associate or customer is not deductible unless business is discussed before, during, or after the meal. This requirement does not apply to meals consumed while away from home in travel status.

EXAMPLE 40

Lacy travels to San Francisco for a business convention. She pays for dinner with three colleagues and is not reimbursed by her employer. They do not discuss business. She can deduct 50% of the cost of her meal. However, she cannot deduct the cost of her colleagues' meals. ■

EXAMPLE 41

Lance, a party to a contract negotiation, buys dinner for other parties to the negotiation but does not attend the dinner. No deduction is allowed because Lance was not present. ■

Restrictions upon Deductibility of Club Dues

The Code provides that "No deduction shall be allowed ... for amounts paid or incurred for membership in any club organized for business, pleasure, recreation, or other social purpose."[65] Although this prohibition seems quite broad, it does not apply to clubs whose primary purpose is public service and community volunteerism (e.g., Kiwanis, Lions, Rotary). Although *dues* are not deductible, actual entertainment at a club may qualify.

EXAMPLE 42

During the current year, Vincent spent $1,400 on business lunches at the Lakeside Country Club. The annual membership fee was $6,000, and Vincent used the facility 60% of the time for business. Presuming the lunches meet the business meal test, Vincent may claim $700 (50% cutback × $1,400) as a deduction. None of the club dues are deductible. ■



In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

Business Gifts

Business gifts are deductible to the extent of $25 per donee per year.[66] An exception is made for gifts costing $4 or less (e.g., pens with the employee's or company's name on them) or promotional materials. Such items are not treated as business gifts subject to the $25 limitation. In addition, incidental costs such as engraving of jewelry and nominal charges for gift-wrapping, mailing, and delivery are not included in the cost of the gift in applying the limitation. Gifts to superiors and employers are not deductible. The $25 limitation on business gifts cannot be circumvented by having the donor's spouse join in the gift or by making multiple gifts that include the customer's family. Records must be maintained to substantiate business gifts.

OTHER EMPLOYEE EXPENSES

Office in the Home

Employees and self-employed individuals are not allowed a deduction for **office in the home expenses** unless a portion of the residence is used *exclusively and on a regular basis* as either:

[64] § 274(k).
[65] § 274(a)(3).
[66] § 274(b)(1).

TAX in the NEWS

The Office in the Home Deduction Is Not Being Fully Realized

Due to cost considerations (e.g., the time and expense of commuting) and other factors (e.g., flexible work schedules), more and more employees are telecommuting to their jobs. As a result, the number of taxpayers who take a deduction for maintaining an office in their home has increased. Even so, there is reason to believe that many persons who otherwise qualify are not claiming the deduction. One reason for the omission probably is fear of being audited by the IRS. Is this fear realistic? Does the presence of an office in the home deduction increase the chance that a taxpayer's return will be selected for audit? As the IRS does not release the details of how it chooses returns to audit, this question cannot be answered.

A second reason for not claiming the deduction is its complexity. The taxpayer must not only be familiar with the rules (e.g., exclusive use, on a regular basis, income limit) but must also maintain the proper records. Even if the records are available, are the time and effort required to complete a Form 8829 (Expenses for Business Use of Your Home) worth the tax savings that result?

What is needed is a simpler, optional method for calculating the office in the home deduction. A precedent for such an approach is the automatic (or standard) mileage method that can be used instead of the actual cost method for determining the business use of an automobile. Without the automatic mileage method, many taxpayers would lose a deduction to which they are entitled. Without an optional method for claiming an office in the home deduction, many taxpayers are losing a deduction to which they are entitled.

Source: Adapted from National Taxpayer Advocate 2007 Annual Report to Congress Executive Summary, January 9, 2008.

- The principal place of business for any trade or business of the taxpayer.
- A place of business used by clients, patients, or customers.

Employees must meet an additional test: The use must be for the convenience of the employer rather than merely being "appropriate and helpful."[67]

The precise meaning of "principal place of business" has been the subject of considerable controversy.[68] Congress ultimately resolved the controversy by amending the Code.[69]

The term "principal place of business" now includes a place of business that satisfies the following requirements:

- The office is used by the taxpayer to conduct administrative or management activities of a trade or business.
- There is no other fixed location of the trade or business where the taxpayer conducts these activities.

EXAMPLE 43

Dr. Smith is a self-employed anesthesiologist. During the year, he spends 30 to 35 hours per week administering anesthesia and postoperative care to patients in three hospitals, none of which provides him with an office. He also spends two or three hours per day in a room in his home that he uses exclusively as an office. He does not meet patients there, but he performs a variety of tasks related to his medical practice (e.g., contacting surgeons, bookkeeping, reading medical journals). A deduction will be allowed since he uses the office in the home to conduct administrative or management activities of his trade or business, and there is no other fixed location where these activities can be carried out. ■

The exclusive use requirement means that a specific part of the home must be used solely for business purposes. A deduction, if permitted, requires an allocation of total expenses of operating the home between business and personal use based on floor space or number of rooms.

[67] § 280A(c)(1).

[68] See the restrictive interpretation arrived at in *Comm. v. Soliman*, 93–1 USTC ¶50,014, 71 AFTR 2d 93–463, 113 S.Ct. 701 (USSC, 1993).

[69] § 280A(c)(1) as modified by TRA of 1997.

Even if the taxpayer meets the above requirements, the allowable home office expenses cannot exceed the gross income from the business less all other business expenses attributable to the activity. That is, the home office deduction cannot create a loss. Furthermore, the home office expenses that are allowed as itemized deductions anyway (e.g., mortgage interest and real estate taxes) must be deducted first. All home office expenses of an employee are miscellaneous itemized deductions, except those (such as interest and taxes) that qualify as other personal itemized deductions. Home office expenses of a self-employed individual are trade or business expenses and are deductible *for* AGI. Any disallowed home office expenses are carried forward and used in future years subject to the same limitations.

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft.**



EXAMPLE 14

Rick is a certified public accountant employed by a regional CPA firm as a tax manager. He operates a separate business in which he refinishes furniture in his home. For this business, he uses two rooms in the basement of his home exclusively and regularly. The floor space of the two rooms constitutes 10% of the floor space of his residence. Gross income from the business totals $8,000. Expenses of the business (other than home office expenses) are $6,500. Rick incurs the following home office expenses:

Real property taxes on residence	$ 4,000
Interest expense on residence	7,500
Operating expenses of residence	2,000
Depreciation on residence (related to 10% business use)	250

Rick's deductions are determined as follows:

Business income		$ 8,000
Less: Other business expenses		(6,500)
		$ 1,500
Less: Allocable taxes ($4,000 × 10%)	$400	
Allocable interest ($7,500 × 10%)	750	(1,150)
		$ 350
Less: Allocable operating expenses of the residence ($2,000 × 10%)		(200)
		$ 150
Less: Allocable depreciation ($250, limited to remaining income)		(150)
		$ –0–

Rick has a carryover deduction of $100 (the unused excess depreciation). Because he is self-employed, the allocable taxes and interest ($1,150), the other deductible office expenses ($200 + $150), and $6,500 of other business expenses are deductible *for* AGI. ■

Certain Expenses for Teachers

Recent tax legislation provides for a deduction *for* AGI for certain expenses of elementary and secondary school teachers.[70] Many teachers purchase school supplies for classroom use and are not reimbursed by their employer. Such teachers may deduct the costs they incur for books, supplies, computer equipment and related software and services, other equipment, and supplementary materials that they use in the classroom. The annual statutory ceiling on the deduction *for* AGI classification is $250.

[70] § 62(a)(2)(D).

Tax Planning Strategies UNREIMBURSED EMPLOYEE BUSINESS EXPENSES

FRAMEWORK FOCUS: DEDUCTIONS

Strategy: Maximize Deductible Amounts.

The 2 percent floor for unreimbursed employee business expenses offers a tax planning opportunity for married couples. If one spouse has high miscellaneous expenses subject to the floor, it may be beneficial for the couple to file separate returns. If they file jointly, the 2 percent floor is based on the adjusted gross incomes of both. Filing separately lowers the reduction to 2 percent of only one spouse's adjusted gross income.

Other provisions of the law should be considered, however. For example, filing separately could cost a couple losses of up to $25,000 from self-managed rental units under the passive activity loss rules (discussed in Chapter 6).

Another possibility is to negotiate a salary reduction with one's employer in exchange for the 100 percent reimbursement of employee expenses. The employee is better off because the 2 percent floor does not apply. The employer is better off because certain expense reimbursements are not subject to Social Security and other payroll taxes.

Unreimbursed Expenses

Unreimbursed employee expenses are treated in a straightforward manner. Meals and entertainment expenses are subject to the 50 percent limit. Total unreimbursed employee business expenses are usually reported as miscellaneous itemized deductions subject to the 2 percent-of-AGI floor (refer to Chapter 16). If the employee could have received, but did not seek, reimbursement for whatever reason, none of the employment-related expenses are deductible.

DIGGING DEEPER 19

In-depth coverage can be found on this book's companion website at: **www.cengage.com/taxation/swft**.

CONTRIBUTIONS TO INDIVIDUAL RETIREMENT ACCOUNTS

Traditional IRAs

Employees not covered by another qualified plan can establish their own tax-deductible **Individual Retirement Accounts (IRAs)**. For 2009 and 2010, the contribution ceiling is the smaller of $5,000 (or $10,000 for spousal IRAs) or 100 percent of compensation.[77] The contribution ceiling applies to all types of IRAs (traditional deductible, traditional nondeductible, and Roth). If the taxpayer is an active participant in a qualified plan, the traditional IRA deduction limitation is phased out *proportionately* between certain AGI ranges, as shown in Table 17.3.[78]

An individual who attains the age of 50 by the end of the tax year can make additional catch-up IRA contributions. The maximum contribution limit is increased by $1,000 for years after 2005.

AGI is calculated taking into account any § 469 passive losses and § 86 taxable Social Security benefits and ignoring any § 911 foreign income exclusion, § 135 savings bonds interest exclusion, and the IRA deduction. There is a $200 floor on the IRA deduction limitation for individuals whose AGI is not above the phaseout range.

[77] §§ 219(b)(1) and (c)(2). After 2008, the limit is adjusted annually for inflation in $500 increments.

[78] § 219(g).

TABLE 17.3 Phaseout of Traditional IRA Deduction of an Active Participant in 2010

AGI Filing Status	Phaseout Begins*	Phaseout Ends
Single and head of household	$56,000	$66,000
Married, filing joint return	89,000	99,000
Married, filing separate return	–0–	10,000

*These amounts are indexed annually for inflation.

EXAMPLE 16

Dan, who is single, has compensation income of $62,000 in 2010. He is an active participant in his employer's qualified retirement plan. Dan contributes $5,000 to a traditional IRA. The deductible amount is reduced from $5,000 by $3,000 because of the phaseout mechanism:

$$\frac{\$6,000}{\$10,000} \times \$5,000 = \$3,000 \text{ reduction.}$$

Therefore, of the $5,000 contribution, Dan can deduct only $2,000 ($5,000 − $3,000). ■

EXAMPLE 17

Ben, an unmarried individual, is an active participant in his employer's qualified retirement plan in 2010. With AGI of $65,800, he would normally have an IRA deduction limit of $100 {$5,000 − [($65,800 − $56,000)/$10,000 × $5,000]}. However, because of the special floor provision, Ben is allowed a $200 IRA deduction. ■

An individual is not considered an active participant in a qualified plan merely because the individual's spouse is an active participant in such a plan for any part of a plan year. Thus, most homemakers may take a full $5,000 deduction regardless of the participation status of their spouse, unless the couple has AGI above $167,000. If their AGI is above $167,000, the phaseout of the deduction begins at $167,000 and ends at $177,000 (phaseout over the $10,000 range) rather than beginning and ending at the phaseout amounts in Table 17.3.[79]

EXAMPLE 18

Nell is covered by a qualified employer retirement plan at work. Her husband, Nick, is not an active participant in a qualified plan. If Nell and Nick's combined AGI is $135,000, Nell cannot make a deductible IRA contribution because she exceeds the income threshold for an active participant. However, since Nick is not an active participant, and their combined AGI does not exceed $167,000, he can make a deductible contribution of $5,000 to an IRA. ■

To the extent that an individual is ineligible to make a deductible contribution to an IRA, *nondeductible contributions* can be made to separate accounts. The nondeductible contributions are subject to the same dollar limits as deductible contributions ($5,000 of earned income, $10,000 for a spousal IRA). Income in the account accumulates tax-free until distributed. Only the account earnings are taxed upon distribution because the account basis equals the contributions made by the taxpayer. A taxpayer may elect to treat deductible IRA contributions as nondeductible. If an individual has no taxable income for the year after taking into account other deductions, the election would be beneficial. The election is made on the individual's tax return for the taxable year to which the designation relates.

[79] § 219(g)(7).

TAX IN THE NEWS: THE VACILLATING POPULARITY OF IRAS

Individual Retirement Accounts (IRAs) became part of the tax law in 1974. The number of individual income tax returns indicating IRA contributions has varied over time, as the table below shows.

What probably caused the substantial decline between 1985 and 1990? Tax legislation enacted in 1986 applied the *wherewithal to pay* concept in providing for the phaseout of the IRA deduction once an AGI threshold was reached. In addition, the legislation substantially reduced tax rates for the individual taxpayer.

Year	Number of Returns (in Millions)
1975	1.2
1980	2.6
1985	16.2
1990	5.2
1995	4.3
2000	5.8
2005	4.1

Source: IRS Tax Statistics.

Roth IRAs

A Roth IRA is a *nondeductible* alternative to the traditional deductible IRA. Introduced by Congress to encourage individual savings, earnings inside a Roth IRA are not taxable, and all qualified distributions from a Roth IRA are tax-free.[80] The maximum allowable annual contribution to a Roth IRA for 2010 is the smaller of $5,000 ($10,000 for spousal IRAs) or 100 percent of the individual's compensation for the year. Contributions to a Roth IRA must be made by the due date (excluding extensions) of the taxpayer's tax return. Roth IRAs are not subject to the minimum distribution rules that apply to traditional IRAs. Contributions to a Roth IRA (unlike a traditional IRA) may continue beyond age 70½ so long as the person generates compensation income and is not barred by the AGI limits.

A taxpayer can make tax-free withdrawals from a Roth IRA after an initial five-year holding period if any of the following requirements is satisfied:

- The distribution is made on or after the date on which the participant attains age 59½.
- The distribution is made to a beneficiary (or the participant's estate) on or after the participant's death.
- The participant becomes disabled.
- The distribution is used to pay for qualified first-time homebuyer's expenses (statutory ceiling of $10,000).

EXAMPLE 31

Edith establishes a Roth IRA at age 42 and contributes $5,000 per year for 20 years. The account is now worth $149,400, consisting of $100,000 of nondeductible contributions and $49,400 in accumulated earnings that have not been taxed. Edith may withdraw

[80] § 408A.

TAX in the NEWS

IRA Losses from a Ponzi Scheme

The Bernard Madoff and Mark Stanford Ponzi schemes have affected many taxpayers who had IRA plans with Madoff or Stanford. If a taxpayer had a traditional IRA and all contributions were deductible, the individual has a zero basis, so no loss deduction is available for the losses associated with these Ponzi schemes. If the IRA included some nondeductible contributions, a loss might be deductible if the individual withdraws the entire amount from the IRA. The miscellaneous itemized deduction, subject to the 2 percent floor, would be the difference between the basis and the amount withdrawn. Of course, there may be a 10 percent penalty tax if the withdrawal is an early withdrawal.

A taxpayer with a Roth IRA is more likely to obtain a loss deduction associated with these Ponzi schemes because Roth IRA contributions are nondeductible. The miscellaneous itemized deduction would be the amount contributed (i.e., the basis) less the value of any assets distributed to the Roth IRA owner.

the $149,400 tax-free from the Roth IRA because she is over age 59½ and has met the five-year holding period requirement. ■

If the taxpayer receives a distribution from a Roth IRA and does not satisfy the aforementioned requirements, the distribution may be taxable. If the distribution represents a return of capital, it is not taxable. Conversely, if the distribution represents a payout of earnings, it is taxable. Under the ordering rules for Roth IRA distributions, distributions are treated as first made from contributions (return of capital).

EXAMPLE 52

Assume the same facts as in Example 51, except that Edith is only age 50 and receives a distribution of $55,000. Since her adjusted basis for the Roth IRA is $100,000 (contributions made), the distribution is tax-free, and her adjusted basis is reduced to $45,000 ($100,000 – $55,000). ■

Roth IRAs are subject to income limits. The income limits for Roth IRA contributions are indexed for tax years after 2006. The maximum annual contribution of $5,000 in 2010 is phased out beginning at AGI of $105,000 for single taxpayers and $167,000 for married couples who file a joint return. The phaseout range is $10,000 for married filing jointly and $15,000 for single taxpayers. For a married taxpayer filing separately, the contribution is phased out over a range beginning with AGI of $0 and ending with $10,000.

EXAMPLE 53

Bev, who is single, would like to contribute $5,000 to her Roth IRA. However, her AGI in 2010 is $115,000, so her contribution is limited to $1,667 ($5,000 – $3,333) calculated as follows:

$$\frac{\$10,000}{\$15,000} \times \$5,000 = \$3,333 \text{ reduction}$$

■

Coverdell Education Savings Accounts (CESAs)

Distributions from a **Coverdell Education Savings Account (CESA)** to pay for qualified education expenses receive favorable tax treatment.[81] Qualified education expenses include tuition, fees, books, supplies, and related equipment. Room and board qualify if the student's course load is at least one-half of the full-time course load. If the CESA is used to pay the qualified education expenses of the designated beneficiary, the withdrawals are tax-free. To the extent the distributions during a tax year exceed

[81] § 530.

qualified education expenses, part of the excess is treated as a return of capital (the contributions), and part is treated as a distribution of earnings under the § 72 annuity rules. Thus, the distribution is presumed to be pro rata from each category. The exclusion for the distribution of earnings part is calculated as follows:

$$\frac{\text{Qualified education expenses}}{\text{Total distributions}} \times \text{Earnings} = \text{Exclusion}$$

EXAMPLE 24

Meg receives a $2,500 distribution from her CESA. She uses $2,000 to pay for qualified education expenses. On the date of the distribution, Meg's CESA balance is $10,000, $6,000 of which represents her contributions. Since 60% ($6,000/$10,000) of her account balance represents her contributions, $1,500 ($2,500 × 60%) of the distribution is a return of capital, and $1,000 ($2,500 × 40%) is a distribution of earnings. The excludible amount of the earnings is calculated as follows:

$$\frac{\$2,000}{\$2,500} \times \$1,000 = \$800$$

Thus, Meg must include $200 ($1,000 − $800) in her gross income. ■

The maximum amount that can be contributed annually to a CESA for a beneficiary is $2,000. A beneficiary must be an individual and cannot be a group of children or an unborn child. The contributions are not deductible. A CESA is subject to income limits. The maximum annual contribution is phased out beginning at $95,000 for single taxpayers and $190,000 for married couples who file a joint return. The phaseout range is $30,000 for married filing jointly and $15,000 for single taxpayers. Contributions cannot be made to a CESA after the date on which the designated beneficiary attains age 18. Thus, a total of up to $36,000 can be contributed for each beneficiary—$2,000 in the year of birth and in each of the 17 following years.

A 6 percent excise tax is imposed on excess contributions to a CESA. A 10 percent excise tax is imposed on any distributions that are included in gross income.

The balance in a CESA must be distributed within 30 days after the death of a beneficiary or within 30 days after a beneficiary reaches age 30. Any balance at the close of either 30-day period is considered to be distributed at such time, and the earnings portion is included in the beneficiary's gross income. Before a beneficiary reaches age 30, any balance can be rolled over tax-free into another CESA for a member of the beneficiary's family who is under age 30.

The CESA exclusion may be available in a tax year in which the beneficiary claims the American Opportunity credit or the lifetime learning credit (see Chapter 16). However, any excluded amount of the CESA distribution cannot be used for the same educational expenses for which the American Opportunity credit or the lifetime learning credit is claimed.

Contributions cannot be made to a beneficiary's CESA during any year in which contributions are made to a qualified tuition program on behalf of the same beneficiary.

17.4 Individuals as Proprietors

LO.5

Understand the tax provisions applicable to proprietors.

THE PROPRIETORSHIP AS A BUSINESS ENTITY

A sole proprietorship is *not* a taxable entity separate from the individual who owns the proprietorship. A sole proprietor reports the results of business operations of the proprietorship on Schedule C of Form 1040. The net profit or loss from the proprietorship is then transferred from Schedule C to Form 1040, which is used by the taxpayer to determine tax liability. The proprietor reports all of the net profit or net loss from the business, regardless of the amount actually withdrawn from the proprietorship during the year.

Income and expenses of the proprietorship retain their character when reported by the proprietor. For example, ordinary income of the proprietorship is treated as ordinary income when reported by the proprietor, and capital gain of the proprietorship is treated as capital gain by the proprietor.

George is the sole proprietor of George's Record Shop. Gross income of the business in 2010 is $200,000, and operating expenses are $110,000. George also sells a capital asset held by the business for a $10,000 long-term capital gain. During 2010, he withdraws $60,000 from the business for living expenses. George reports the operating income and expenses of the business on Schedule C, resulting in net profit (ordinary income) of $90,000 ($200,000 − $110,000). Even though he withdrew only $60,000, George reports all of the $90,000 net profit from the business on Form 1040, where he computes taxable income and the tax liability for the year. He also reports a $10,000 long-term capital gain on his personal tax return (Schedule D of Form 1040). ■

INCOME OF A PROPRIETORSHIP

The broad definition of gross income in § 61(a) applies equally to individuals and business entities, including proprietorships, corporations, and partnerships. Thus, it is assumed that asset inflows into a proprietorship are to be treated as income. Certain items may be excluded from gross income. Many of the exclusions available to an individual are related to the individual as an employee. Refer to Chapter 4 for a detailed discussion of gross income.

DEDUCTIONS RELATED TO A PROPRIETORSHIP

Ordinary and Necessary Business Expenses

The provisions that govern business deductions also are general, and not entity specific. The § 162 requirement that trade or business expenses be *ordinary and necessary* (refer to Chapter 5) applies to proprietorships as well as corporations, partnerships, and other business entities. However, certain specific deductions are available only to self-employed taxpayers. These deductions are covered in detail below.

Health Insurance Premiums

A self-employed taxpayer may deduct 100 percent of insurance premiums paid for medical coverage as a deduction *for* AGI.[82] The deduction is allowed for premiums paid on behalf of the taxpayer, the taxpayer's spouse, and dependents of the taxpayer. The deduction is not allowed to any taxpayer who is eligible to participate in a subsidized health plan maintained by any employer of the taxpayer or of the taxpayer's spouse.

This deduction is reported in the Adjusted Gross Income section of Form 1040 rather than on Schedule C. Premiums paid for medical coverage of the *employees* of a self-employed taxpayer are deductible as business expenses on Schedule C, however.

Ellen, a sole proprietor of a restaurant, has two dependent children. During 2010, she paid health insurance premiums of $1,800 for her own coverage and $1,000 for coverage of her two children. Ellen can deduct $2,800 as a deduction *for* AGI. ■

Self-Employment Tax

The tax on self-employment income is levied to provide Social Security and Medicare benefits (old age, survivors, and disability insurance and hospital insurance) for self-employed individuals. Individuals with net earnings of $400 or more from self-employment are subject to the self-employment tax.[83] For 2010, the self-employment tax is

[82] § 162(l).

[83] § 6017.

TAX in the NEWS

The Tax Gap Includes $58 Billion in Payroll Taxes

The "tax gap"—the difference between what taxpayers owe to the Federal government in taxes and what they pay—is approaching $400 billion annually. A significant portion of that amount consists of delinquent payroll taxes—the money withheld from employees' salaries by employers for FICA taxes (Social Security and Medicare taxes).

According to a study by the Government Accountability Office (GAO), more than 1.6 million businesses together owe in excess of $58 billion related to delinquent payroll taxes. Of that amount, $26 billion represents actual taxes owed, $18 billion is for interest, and $14 billion is for penalties. In contrast, businesses owe only $24 billion in delinquent corporate income taxes. Businesses in the construction, professional services, and health care industries have the largest payroll tax delinquencies.

Collecting payroll taxes seems to be a perennial problem. The GAO study pointed out that delinquencies today are about the same as they were a decade ago when 1.8 million businesses owed about $49 billion. Today, though, debts are more likely to be longstanding. About 500 employers owe at least 10 years' worth of taxes, and nearly 15,000 owe 5 years' worth. About half of the $58 billion owed is from 2002 or earlier. Since then the IRS has stepped up its enforcement efforts through the use of liens and levies on businesses that fail to pay over the taxes withheld.

Source: Adapted from "Businesses Owe IRS $58 Billion," *USA Today* (online), July 28, 2008.

12.4 percent of self-employment earnings up to a $106,800 *ceiling amount* (for the Social Security portion) plus 2.9 percent of the *total* amount of self-employment earnings (for the Medicare portion). Thus, the combined self-employment tax rate on earnings up to $106,800 is 15.3 percent. The ceiling amount is adjusted annually for inflation.

For purposes of computing the *self-employment tax,* self-employed taxpayers are allowed a deduction from net earnings equal to one-half of the self-employment tax rate.[84] This deduction of 7.65 percent (one-half of the 15.3 percent rate) is reflected by multiplying net earnings from self-employment by 92.35 percent (100% − 7.65%), as shown in Example 57. For purposes of computing *taxable income,* an income tax deduction is allowed for one-half the amount of self-employment tax paid.[85]

Example 57 illustrates the computation of the self-employment tax, as well as the income tax deduction for one-half of self-employment tax paid. For income tax purposes, the amount to be reported on Schedule C is net earnings from self-employment *before* the deduction for one-half of the self-employment tax. The deduction of one-half of the self-employment tax paid is reported separately on Form 1040 as a deduction *for* AGI.

EXAMPLE 57

Computation of the self-employment tax is determined using the steps below. The self-employment tax is determined for two taxpayers with net earnings from self-employment for 2010 as follows: Ned, $55,000 and Terry, $120,000.

Computation of Self-Employment Tax for Ned	
1. Net earnings	$55,000.00
2. Multiply line 1 by 92.35%.	$50,792.50
3. If the amount on line 2 is $106,800 or less, multiply the line 2 amount by 15.3%. This is the self-employment tax.	$ 7,771.25
4. If the amount on line 2 is more than $106,800, multiply the excess over $106,800 by 2.9% and add $16,340.40. This is the self-employment tax.	

[84] § 1402(a)(12).

[85] § 164(f).

Computation of Self-Employment Tax for Terry	
1. Net earnings	$120,000.00
2. Multiply line 1 by 92.35%.	$110,820.00
3. If the amount on line 2 is $106,800 or less, multiply the line 2 amount by 15.3%. This is the self-employment tax.	
4. If the amount on line 2 is more than $106,800, multiply the excess over $106,800 by 2.9% and add $16,340.40. This is the self-employment tax.	$ 16,456.98

For income tax purposes, Ned has net earnings from self-employment of $55,000 and a deduction *for* AGI of $3,885.63 (one-half of $7,771.25). Terry has net earnings from self-employment of $120,000 and a deduction *for* AGI of $8,228.49 (one-half of $16,456.98). Both taxpayers benefit from the deduction for one-half of the self-employment tax paid. ■

Wages of employees also are subject to Social Security and Medicare taxes. The total tax rate is also 15.3 percent, with 7.65 percent being withheld from the employee's wages and the employer paying at a 7.65 percent rate. If an individual who is self-employed also receives wages from working as an employee of another organization, the ceiling amount of the Social Security portion on which the self-employment tax is computed is reduced. Thus, the self-employment tax may be reduced if a self-employed individual also receives Social Security wages in excess of the ceiling amount.

Net earnings from self-employment include gross income from a trade or business less allowable trade or business deductions, the distributive share of any partnership income or loss derived from a trade or business activity, and net income from rendering personal services as an independent contractor. Gain or loss from the disposition of property (including involuntary conversions) is excluded from the computation of self-employment income unless the property involved is inventory.

RETIREMENT PLANS FOR SELF-EMPLOYED INDIVIDUALS

Self-employed individuals have several options for retirement funding. Individual Retirement Accounts (discussed earlier in this chapter) are available to both employees and self-employed individuals. Other options for self-employed individuals include, but are not limited to, H.R. 10 (Keogh) plans and SIMPLE plans, both of which are discussed below.

Keogh Plans

Self-employed individuals (e.g., partners and sole proprietors) are eligible to establish and receive qualified retirement benefits under **Keogh plans** (also known as H.R. 10 plans). Self-employed individuals who establish Keogh plans for themselves are also required to cover their *employees* under the plan.

Keogh investments can include a variety of funding vehicles, such as mutual funds, annuities, real estate shares, certificates of deposit, debt instruments, commodities, securities, and personal properties. When an individual decides to make all investment decisions, a *self-directed retirement plan* is established. Investment in most collectibles is not allowed in a self-directed plan.

A Keogh plan may be either a *defined contribution* plan or a *defined benefit* plan. In a defined contribution plan, the amount that can be contributed each year is subject to limitations. Retirement benefits depend on the amount contributed and the amount earned by the plan. In a defined benefit plan, the amount of retirement income is fixed and is determined on the basis of the employee's compensation while working, the number of years in the plan, and age on retirement.

A self-employed individual may annually contribute the smaller of $49,000 (in 2010) or 100 percent of earned income to a defined contribution Keogh plan.[86] If

[86] § 415(c)(1).

TAX FACT

Increasing Popularity of Keogh Plans

Keogh plans are an increasingly popular retirement savings device for self-employed taxpayers. The number of individual income tax returns that included Keogh contributions is indicated below.

Year	Number of Returns (in Thousands)
1975	596
1980	569
1985	676
1990	824
1995	1,032
2000	1,228
2005	1,257

Source: IRS Tax Statistics.

the defined contribution plan is a profit sharing plan or stock bonus plan, however, a 25 percent deduction limit applies. Under a defined benefit Keogh plan, the annual benefit is limited to the smaller of $195,000 (in 2010) or 100 percent of the average net earnings for the three highest years.[87]

Earned income refers to net earnings from self-employment.[88] Net earnings from self-employment means the gross income derived by an individual from any trade or business carried on by that individual, less appropriate deductions, plus the distributive share of income or loss from a partnership.[89] Earned income is reduced by contributions to a Keogh plan on the individual's behalf and by 50 percent of any self-employment tax.[90]

EXAMPLE 56

Pat, a partner, has earned income of $150,000 in 2010 (after the deduction for one-half of self-employment tax, but before any Keogh contribution). The maximum contribution Pat may make to a defined contribution Keogh plan is $49,000, the lesser of $150,000 or $49,000. ■

For discrimination purposes, the 25 percent limitation on the employee contribution to a profit sharing plan or stock bonus plan is computed on the first $245,000 (in 2010) of earned income. Thus, the maximum contribution in 2010 is $49,000 ($245,000 − .25X = X; X = $196,000). Therefore, $245,000 − $196,000 = $49,000. Alternatively, this can be calculated by multiplying $245,000 by 20 percent.

EXAMPLE 57

Terry, a self-employed accountant, has a profit sharing plan with a contribution rate of 15% of compensation. Terry's earned income after the deduction of one-half of self-employment tax, but before the Keogh contribution, is $250,000. Terry's contribution is limited to $31,957 ($245,000 − .15X = X), since X = $213,043 and .15 × $213,043 = $31,957. ■

Although a Keogh plan must be established before the end of the year in question, contributions may be made up to the normal filing date for that year.

[87] § 415(b)(1). The amount is indexed annually.
[88] § 401(c)(2).
[89] § 1402(a).
[90] §§ 401(c)(2)(A)(v) and 164(f).

Tax Planning Strategies IMPORTANT DATES RELATED TO IRAS AND KEOGH PLANS

FRAMEWORK FOCUS: DEDUCTIONS

Strategy: Accelerate Recognition of Deductions to Achieve Tax Deferral.

A Keogh or IRA participant may make a deductible contribution for a tax year up to the time prescribed for filing the individual's tax return for that tax year. A Keogh plan must have been *established* by the end of the *prior* tax year (e.g., December 31, 2009) to obtain a deduction on the 2009 income tax return for the contribution made in the *current* year (2010). An individual can establish an IRA during the *current* tax year (up to the normal filing date) and still receive a deduction on the prior-year income tax return for the contribution made in the *current* year.

SIMPLE Plans

Employers with 100 or fewer employees who do not maintain another qualified retirement plan may establish a *savings incentive match plan for employees* (SIMPLE plan).[91] The plan can be in the form of a § 401(k) plan or an IRA. A SIMPLE § 401(k) plan is not subject to the nondiscrimination rules that are normally applicable to § 401(k) plans.

All employees who received at least $5,000 in compensation from the employer during any two preceding years and who reasonably expect to receive at least $5,000 in compensation during the current year must be eligible to participate in the plan. The decision to participate is up to the employee. A *self-employed individual* may also participate in the plan.

The contributions made by the employee (a salary reduction approach) must be expressed as a percentage of compensation rather than as a fixed dollar amount. The SIMPLE plan must not permit the elective employee contribution for the year to exceed $11,500 (in 2010).[92] The SIMPLE elective deferral limit is increased under the catch-up provision for employees age 50 and over. The amount is $2,000 for 2005 and $2,500 for 2006 and thereafter. The $2,500 amount is indexed for inflation in $500 increments beginning in 2007 (remains at $2,500 for 2007, 2008, 2009, and 2010).

Generally, the employer must either match elective employee contributions up to 3 percent of the employee's compensation or provide nonmatching contributions of 2 percent of compensation for each eligible employee. Thus, the maximum amount that may be contributed for an employee under age 50 to the plan for 2010 is $18,850 [$11,500 employee contributions + $7,350 ($245,000 compensation ceiling × 3%) employer match].

No other contributions may be made to the plan other than the employee elective contribution and the required employer matching contribution (or nonmatching contribution under the 2 percent rule). All contributions are fully vested. An employer is required to make the required matching or nonmatching contributions to a SIMPLE § 401(k) plan once it is established, whereas an employer's contributions to a traditional § 401(k) plan generally may be discretionary.

An employer's deduction for contributions to a SIMPLE § 401(k) plan is limited to the greater of 25 percent of the compensation paid or accrued or the amount that the employer is required to contribute to the plan. Thus, an employer may deduct contributions to a SIMPLE § 401(k) plan in excess of 25 percent of the $245,000

[91] § 408(p).

[92] For 2005, the limit was $10,000. This amount is indexed for inflation in $500 increments in 2006 and thereafter. For 2006, the amount remained at $10,000. For 2007 and 2008, it increased to $10,500. For 2009, it increased to $11,500.

salary cap. A traditional § 401(k) plan is limited to 25 percent of the total compensation of plan participants for the year (excluding age 50 catch-ups).

An employer is allowed a deduction for matching contributions only if the contributions are made by the due date (including extensions) for the employer's tax return. Contributions to a SIMPLE plan are excludible from the employee's gross income, and the SIMPLE plan is tax-exempt.

EXAMPLE 60

The Mauve Company has a SIMPLE plan for its employees under which it provides nonmatching contributions of 2% of compensation for each eligible employee. The maximum amount that can be added to each participant's account in 2010 is $16,400, composed of the $11,500 employee salary reduction plus an employer contribution of $4,900 ($245,000 × 2%). ■

Distributions from a SIMPLE plan are taxed under the IRA rules. Tax-free rollovers can be made from one SIMPLE account to another. A SIMPLE account can be rolled over to an IRA tax-free after the expiration of a two-year period since the individual first participated in the plan. Withdrawals of contributions during the two-year period beginning on the date an employee first participates in the SIMPLE plan are subject to a 25 percent early withdrawal tax rather than the 10 percent early withdrawal tax that otherwise would apply.

Tax Planning Strategies **FACTORS AFFECTING RETIREMENT PLAN CHOICES**

FRAMEWORK FOCUS: DEDUCTIONS

Strategy: Maximize Deductible Amounts.

An IRA might not be the best retirement plan option for many self-employed taxpayers. The maximum amount that can be deducted is $5,000 per year ($10,000 for a spousal plan), which may be too low to provide funding for an adequate level of retirement income. Other options such as Keogh plans and SIMPLE plans allow larger contributions and larger deductions. However, a self-employed individual who establishes either a Keogh or a SIMPLE plan is required to cover employees under such plans. This can result in substantial expenditures, not only for the required contributions, but also for expenses of administering the plan. An advantage of an IRA is that coverage of employees is not required.

ACCOUNTING PERIODS AND METHODS

Proprietors may choose among accounting methods, just as other business entities do (refer to Chapter 4 and Chapter 5). The cash method is commonly used by proprietorships that provide services, while the accrual or hybrid method generally is required if inventory is a material income-producing factor.

The accounting period rules for proprietorships generally are much simpler than the rules for partnerships and S corporations. Because a proprietorship is not an entity separate from the proprietor, the proprietorship must use the same tax year-end as the proprietor. This does not preclude the use of a fiscal year for a proprietorship, but most proprietorships use the calendar year.

ESTIMATED TAX PAYMENTS

Although the following discussion largely centers on self-employed taxpayers, some of the procedures may be applicable to employed persons. In many cases, for example, employed persons may be required to pay estimated tax if they have income that is not subject to withholding (e.g., income from rentals, dividends, or interest).

Estimated Tax for Individuals

Estimated tax is the amount of tax (including alternative minimum tax and self-employment tax) an individual expects to owe for the year after subtracting tax credits and income tax withheld. Any individual who has estimated tax for the year of $1,000 or more and whose withholding does not equal or exceed the required annual payment (discussed below) must make quarterly payments.[93] Otherwise, a penalty may be assessed. No quarterly payments are required, and no penalty will apply on an underpayment, if the taxpayer's estimated tax is under $1,000. No penalty will apply if the taxpayer had no tax liability for the preceding tax year, the preceding tax year was a taxable year of 12 months, and the taxpayer was a citizen or resident for the entire preceding tax year. In this regard, having no tax liability is not the same as having no additional tax to pay.

The required annual payment must first be computed. This is the smaller of the following amounts:

- Ninety percent of the tax shown on the current year's return.
- One hundred percent of the tax shown on the preceding year's return (the return must cover the full 12 months of the preceding year). If the AGI on the preceding year's return exceeds $150,000 ($75,000 if married filing separately), the 100 percent requirement is increased to 110 percent.

In general, one-fourth of this required annual payment is due on April 15, June 15, and September 15 of the tax year and January 15 of the following year. Thus, the quarterly installment of the required annual payment reduced by the applicable withholding is the estimated tax to be paid. An equal part of withholding is deemed paid on each due date, even if a taxpayer's earnings fluctuate widely during the year. Payments are to be accompanied by the payment voucher from Form 1040–ES for the appropriate date.

Penalty on Underpayments

A nondeductible penalty is imposed on the amount of underpayment of estimated tax. The rate for this penalty is adjusted quarterly to reflect changes in the average prime rate.

An *underpayment* occurs when any quarterly payment (the sum of estimated tax paid and income tax withheld) is less than 25 percent of the required annual payment. The penalty is applied to the amount of the underpayment for the period of the underpayment.[94]

Marta made the following payments of estimated tax for 2010 and had no income tax withheld:

April 15, 2010	$1,400
June 15, 2010	2,300
September 15, 2010	1,500
January 18, 2011	1,800

Marta's actual tax for 2010 is $8,000, and her tax in 2009 was $10,000. Therefore, each installment should have been at least $1,800 [($8,000 × 90%) × 25%]. Of the payment on June 15, $400 will be credited to the unpaid balance of the first quarterly installment due on April 15,[95] thereby effectively stopping the underpayment penalty for the first quarterly period. Of the remaining $1,900 payment on June 15, $100 is credited to the September 15 payment, resulting in this third quarterly payment being $200 short. Then $200 of the January 18, 2011 payment is credited to the September

[93] § 6654(c)(1).

[94] § 6654(b)(2).

[95] Payments are credited to unpaid installments in the order in which the installments are required to be paid. § 6654(b)(3).

15 shortfall, ending the period of underpayment for that portion due. The January 18, 2011 installment is now underpaid by $200, and a penalty will apply from January 18, 2011, to April 15, 2011 (unless paid sooner). Marta's underpayments for the periods of underpayment are as follows:

1st installment due:	$400 from April 15, 2010 to June 15, 2010
2nd installment due:	Paid in full
3rd installment due:	$200 from September 15, 2010 to January 18, 2011
4th installment due:	$200 from January 18, 2011 to April 15, 2011 ■

If a possible underpayment of estimated tax is indicated, Form 2210 should be filed to compute the penalty due or to justify that no penalty applies.

17.5 Hobby Losses

LO.6

Distinguish between business and hobby activities and apply the rules limiting the deduction of hobby losses.

Employee deductions and deductions related to a proprietorship were discussed in previous sections of this chapter. Employees are allowed to deduct certain expenditures incurred in connection with their work activities. Expenses incurred by a self-employed taxpayer are deductible only if the taxpayer can show that the activity was entered into for the purpose of making a profit.

Certain activities may have either profit-seeking or personal attributes, depending upon individual circumstances. Examples include raising horses and operating a farm that is also used as a weekend residence. While personal losses are not deductible, losses attributable to profit-seeking activities may be deducted and used to offset a taxpayer's other income. For this reason, losses generated by hobbies are not deductible.

GENERAL RULES

If an individual can show that an activity has been conducted with the intent to earn a profit, losses from the activity are fully deductible. The hobby loss rules apply only if the activity is not engaged in for profit. Hobby expenses are deductible only to the extent of hobby income.[96]

The Regulations stipulate that the following nine factors should be considered in determining whether an activity is profit seeking or a hobby:[97]

- Whether the activity is conducted in a businesslike manner.
- The expertise of the taxpayers or their advisers.
- The time and effort expended.
- The expectation that the assets of the activity will appreciate in value.
- The taxpayer's previous success in conducting similar activities.
- The history of income or losses from the activity.
- The relationship of profits earned to losses incurred.
- The financial status of the taxpayer (e.g., if the taxpayer does not have substantial amounts of other income, this may indicate that the activity is engaged in for profit).
- Elements of personal pleasure or recreation in the activity.

The presence or absence of a factor is not by itself determinative of whether the activity is profit seeking or a hobby. Rather, the decision is a subjective one that is based on an analysis of the facts and circumstances.

PRESUMPTIVE RULE OF § 183

The Code provides a rebuttable presumption that an activity is profit seeking if the activity shows a profit in at least three of any five prior consecutive years.[98] If the

[96] § 183(b)(2).
[97] Reg. §§ 1.183–2(b)(1) through (9).
[98] § 183(d).

activity involves horses, a profit in at least two of seven consecutive years meets the presumptive rule. If these profitability tests are met, the activity is presumed to be a trade or business rather than a personal hobby. In this situation, the burden of proof shifts from the taxpayer to the IRS. That is, the IRS bears the burden of proving that the activity is personal rather than trade or business related.

Camille, an executive for a large corporation, is paid a salary of $200,000. Her husband is a collector of antiques. Several years ago, he opened an antique shop in a local shopping center and spends most of his time buying and selling antiques. He occasionally earns a small profit from this activity but more frequently incurs substantial losses. If the losses are business related, they are fully deductible against Camille's salary on a joint return. The following approach should be considered in resolving this issue:

- Initially determine whether the antique activity has met the three-out-of-five-years profit test.
- If the presumption is not met, the activity may nevertheless qualify as a business if the taxpayer can show that the intent is to engage in a profit-seeking activity. It is not necessary to show actual profits.
- Attempt to fit the operation within the nine criteria prescribed in the Regulations and listed above. These criteria are the factors considered in trying to rebut the § 183 presumption. ■

DETERMINING THE AMOUNT OF THE DEDUCTION

If an activity is deemed to be a hobby, the expenses are deductible only to the extent of the gross income from the hobby. These expenses must be deducted in the following order:

- Amounts deductible under other Code Sections without regard to the nature of the activity, such as property taxes and home mortgage interest.
- Amounts deductible under other Code Sections if the activity had been engaged in for profit, but only if those amounts do not affect adjusted basis. Examples include maintenance, utilities, and supplies.
- Amounts that affect adjusted basis and would be deductible under other Code Sections if the activity had been engaged in for profit.[99] Examples include depreciation, amortization, and depletion.

These deductions are deductible *from* AGI as itemized deductions to the extent they exceed 2 percent of AGI.[100] If the taxpayer uses the standard deduction rather than itemizing, all hobby loss deductions are wasted.

Jim, the vice president of an oil company, has AGI of $80,000. He decides to pursue painting in his spare time. He uses a home studio, comprising 10% of the home's square footage. During the current year, Jim incurs the following expenses:

Frames	$ 350
Art supplies	300
Fees paid to models	1,000
Expenses related to home:	
Total property taxes	900
Total home mortgage interest	10,000
Total home maintenance and utilities	3,600
Depreciation on 10% of home used as studio	500

[99]Reg. § 1.183–1(b)(1).

[100]Temp.Reg. § 1.67–1T(a)(1)(iv) and Rev.Rul. 75–14, 1975–1 C.B. 90.

During the year, Jim sold paintings for a total of $3,200. If the activity is held to be a hobby, Jim is allowed deductions as follows:

Gross income		$ 3,200
Deduct: Taxes and interest (10% of $10,900)		(1,090)
Remainder		$ 2,110
Deduct: Frames	$ 350	
Art supplies	300	
Models' fees	1,000	
Maintenance and utilities (10%)	360	(2,010)
Remainder		$ 100
Depreciation ($500, but limited to $100)		(100)
Net income		$ –0–

Jim includes the $3,200 of income in AGI, making his AGI $83,200. The taxes and interest are itemized deductions, deductible in full. Assuming Jim has no other miscellaneous itemized deductions, the remaining expenses of $2,110 are reduced by 2% of his AGI ($1,664); so the net deduction is $446. Since the property taxes and home mortgage interest are deductible anyway, the net effect is a $2,754 ($3,200 less $446) increase in taxable income. ■

TRAMELL 66

If Jim's activity in Example 63 were held to be a business, he could deduct expenses totaling $3,600 *for* AGI, as shown below. All these expenses would be trade or business expenses. His reduction in AGI would be as follows:

Gross income		$ 3,200
Deduct: Taxes and interest	$1,090	
Other business expenses	2,010	
Depreciation	500	(3,600)
Reduction in AGI		($ 400)

As in Example 63, Jim can deduct the remaining property taxes and home mortgage interest of $9,810 ($10,900 – $1,090) as itemized deductions. ■

REFOCUS ON THE BIG PICTURE

SELF-EMPLOYED VERSUS EMPLOYEE—WHAT'S THE DIFFERENCE?

Mark may deduct the ordinary and necessary business expenses incurred by his proprietorship. This includes the $18,000 for rent and utilities and the $12,000 paid to his secretary. The $8,000 paid for equipment can be depreciated or may qualify for immediate expensing under § 179. As a self-employed taxpayer, Mark may deduct 100 percent of the $3,000 of health insurance premiums paid, but only if he is not eligible to participate in the subsidized health plan maintained by Mary's employer. On the other hand, Mark cannot deduct the premiums of $500 paid for his life insurance policy. Mark may want to consider contributing to his own IRA or establishing a Keogh plan or SIMPLE plan to allow for greater contributions. Mark should be aware that in addition to paying income tax on the net income earned by his business, he will also owe self-employment tax at a combined rate of 15.3 percent and will be able to claim an income tax deduction for half of the self-employment tax paid.

While Mary will owe income tax on her $85,000 salary, the health insurance premiums of $3,000 and life insurance premiums paid by her employer qualify as tax-free fringe benefits. In addition, as long as Mary is required to substantiate her travel expenses as part of an accountable plan, none of the travel-related reimbursements need to be included in Mary's gross income. Because Mary is not covered by a qualified retirement plan at work, she can also deduct the entire $5,000 contribution made to her IRA. While the $500 of employee business expenses are technically

CONTINUED

deductible, they provide a tax benefit to Mary only if they exceed 2 percent of the couple's AGI. While Mary is not subject to self-employment tax, she still incurs a 7.65 percent payroll tax related to Social Security and Medicare. Her employer pays the other 7.65 percent.

What If?

In order to improve her skills in her current job, Mary is considering entering an MBA program at a local college. At the same time, to save money while Mary is in school, Mark is considering moving his office into a vacant room in their home. Are Mary's education expenses deductible? Can Mark deduct expenses associated with his home office? As long as the new degree is not required to meet the minimum requirements of her existing job and the degree does not qualify Mary for a new trade or business, Mary's books, tuition, and other related educational expenses are deductible as a miscellaneous itemized deduction. However, like the $500 of other employee business expenses mentioned earlier, the expenses provide a tax benefit only to the extent that they exceed 2 percent of the couple's AGI. As a self-employed individual, Mark is allowed to deduct the costs of a home office as long as the office is used exclusively and on a regular basis as either the principal place of business or a place of business used by his clients and customers. Deductible expenses would include a portion of mortgage interest and property taxes paid on the home; a portion of utilities, repairs and maintenance, and other household expenses; and depreciation on the business portion of the home.

SUGGESTED READINGS

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KEY TERMS

Accountable plan, 17–4
Automatic mileage method, 17–21
Cafeteria plan, 17–12
Coverdell Education Savings Account (CESA), 17–41
Deduction for qualified tuition and related expenses, 17–30
De minimis fringe benefits, 17–16
Education expenses, 17–28
Entertainment expenses, 17–31
Estimated tax, 17–49
Flexible spending plan, 17–13
Foreign earned income exclusion, 17–19
Health Savings Account (HSA), 17–7
Independent contractor, 17–3
Individual Retirement Account (IRA), 17–38
Keogh plans, 17–45
Medical Savings Account (MSA), 17–7
Moving expenses, 17–25
No-additional-cost services, 17–14
Nonaccountable plan, 17–37
Office in the home expenses, 17–33
Qualified employee discounts, 17–15
Qualified transportation fringes, 17–17
Self-employment tax, 17–5
Transportation expenses, 17–20
Travel expenses, 17–22
Working condition fringes, 17–16

PROBLEMS

1. **LO.1** Rob performs services for Dave. In ascertaining whether Rob is an employee or an independent contractor, discuss the relevance of each of the separate factors appearing below:
   a. The work is not performed at Dave's business location.
   b. Rob uses his own helpers to assist him in his work.
   c. Rob makes his services available to others.
   d. As to job skills, Rob provides for his own training.
   e. Rob charges a flat fee on a per-job basis.
   f. Rob reports his expenses on Schedule C.
   g. Dave issues a Form W–2 for the services Rob performs.
   h. Rob is covered by the retirement plan that Dave provides for his employees.
   i. Rob has to file a Schedule SE with his Form 1040.

2. **LO.2** Rex, age 45, is an officer of Blue Company, which provides him with the following nondiscriminatory fringe benefits in 2010:
   - Hospitalization insurance premiums for Rex and his dependents. The cost of the coverage for Rex is $2,700 per year, and the additional cost for his dependents is $3,600 per year. The plan has a $2,000 deductible, but his employer contributed $1,500 to Rex's Health Savings Account. Rex withdrew only $800 from the HSA, and the account earned $50 interest during the year.
   - Long-term care insurance premiums for Rex, at a cost of $3,600 per year.
   - Insurance premiums of $840 for salary continuation payments. Under the plan, Rex will receive his regular salary in the event he is unable to work due to illness. Rex collected $4,500 on the policy to replace lost wages while he was ill during the year.
   - Rex is a part-time student working on his bachelor's degree in engineering. His employer reimbursed his $5,200 tuition under a plan available to all full-time employees.

   Determine the amount Rex must include in gross income.

DECISION MAKING

3. **LO.2** Paul is in the 15% marginal tax bracket, and Betty is in the 35% marginal tax bracket. They each pay $6,300 in health insurance premiums for themselves and their families. Their employer has offered to provide group health insurance, but each employee would have to forgo a $7,000 salary increase. How would the change in compensation affect Paul, Betty, and the employer?

4. **LO.2** Bertha spent the last 60 days of 2010 in a nursing home. The cost of the services provided to her was $14,000. Medicare paid $7,500 toward the cost of her stay. Bertha also received $10,500 of benefits under a long-term care insurance policy she purchased. What is the effect on Bertha's gross income?

5. **LO.2** Does the taxpayer recognize gross income in the following situations?
   a. Ann is a registered nurse working in a community hospital. She is not required to take her lunch on the hospital premises, but she can eat in the cafeteria at no charge. The hospital adopted this policy to encourage employees to stay on the premises and be available in case of emergencies. During the year, Ann ate most of her meals on the premises. The total value of those meals was $1,250.
   b. Ira is the manager of a hotel. His employer will allow him to live in one of the rooms rent-free or receive a $1,800 per month cash allowance for rent. Ira elected to live in the hotel.
   c. Seth is a forest ranger and lives in his employer's cabin in the forest. He is required to live there, and because there are no restaurants nearby, the employer supplies Seth with groceries that he cooks and eats on the premises.
   d. Rocky is a partner in the BAR Ranch (a partnership). He is the full-time manager of the ranch. BAR has a business purpose for Rocky's living on the ranch.

6. **LO.2** Sally and Bill are married and file joint returns. In 2010, Bill, an accountant, has a salary of $75,000, and Sally receives a salary of $25,000 as an apartment manager. What are the tax consequences of the following benefits that Bill and Sally's employers provide?
   a. Bill receives a reimbursement of $5,000 for child care expenses. Sally and Bill have three children who are not yet school age.

b. Bill and Sally are provided a free membership at a local fitness and exercise club that allows them to attend three aerobic exercise sessions per week. The value of this type of membership is $1,600 per year.
c. Bill is provided free parking at work. The value of the parking is $1,800 per year.
d. Sally is provided with a free apartment. Living in this apartment is a condition of her employment. Similar apartments rent for $1,200 per month.

7. **LO.2** Finch Construction Company provides its employees who are carpenters with all of the required tools. However, the company believes that this has led to some employees not taking care of the tools and to the mysterious disappearance of some of the tools. The company is considering requiring all of its employees to provide their own tools. Employees' salaries would be increased by $1,500 to compensate for their additional costs. Write a letter to Finch's management explaining the tax consequences of this plan to the carpenters. Finch's address is 300 Harbor Drive, Vermillion, SD 57069.

COMMUNICATIONS

8. **LO.2** Rosa's employer has instituted a flexible benefits program. Rosa will use the plan to pay for her daughter's dental expenses and other medical expenses that are not covered by health insurance. Rosa is in the 25% marginal tax bracket and estimates that the medical and dental expenses not covered by health insurance will be within the range of $3,000 to $5,000. Her employer's plan permits her to set aside as much as $5,000 in the flexible benefits account. Rosa does not itemize her deductions.
   a. Rosa puts $3,000 into her flexible benefits account, and her actual expenses are $5,000. What is her cost of underestimating the expenses?
   b. Rosa puts $5,000 into her flexible benefits account, and her actual expenses are only $3,000. What is her cost of overestimating her expenses?
   c. What is Rosa's cost of underfunding as compared to the cost of overfunding the flexible benefits account?
   d. Does your answer in part (c) suggest that Rosa should fund the account closer to the low end or to the high end of her estimates?

DECISION MAKING

9. **LO.2** Canary Corporation would like you to review its employee fringe benefits program with regard to the tax consequences of the plan for the company's president (Polly), who is also the majority shareholder:
   a. All executives receive free tickets to State University football games. Polly is not a football fan and usually gives her tickets to another employee. The cost to the employer for Polly's tickets for the year was $600.
   b. The company owns a parking garage that is used by customers, employees, and the general public. Only the general public is required to pay for parking. The charge to the general public for Polly's parking for the year would have been $3,000 (a $250 monthly rate).
   c. All employees are allowed to use the company's fixed charge long-distance telephone services, as long as the privilege is not abused. Although no one has kept track of the actual calls, Polly's use of the telephone had a value (what she would have paid on her personal telephone) of approximately $600.
   d. The company owns a condominium at the beach, which it uses to entertain customers. Employees are allowed to use the facility without charge when the company has no scheduled events. Polly used the facility 10 days during the year. Her use had a rental value of $1,000.
   e. The company is in the household moving business. Employees are allowed to ship goods without charge whenever there is excess space on a truck. Polly purchased a dining room suite for her daughter. Company trucks delivered the furniture to the daughter. Normal freight charges would have been $750.
   f. The company has a storage facility for household goods. Officers are allowed a 20% discount on charges for storing their goods. All other employees are allowed a 10% discount. Polly's discounts for the year totaled $900.

10. **LO.2** Ted works for Sage Motors, an automobile dealership. All employees can buy a car at the company's cost plus 2%. The company does not charge employees the $175 transfer service fee that nonemployees must pay. Ted purchased an automobile for $24,480 ($24,000 + $480). The company's cost was $24,000. The price for a nonemployee would have been $27,775 ($27,600 + $175 transfer service fee). What is Ted's gross income from the purchase of the automobile?

11. **LO.2** Tom works for Roadrunner Motors, a company that manufactures automobiles. Tom purchased a new automobile from Roadrunner at the company's cost of $10,000.

ETHICS AND EQUITY

The retail selling price for the automobile is $15,000. Sue works for Coyote, Inc., an auto dealership, which sells the car manufactured by Roadrunner. Sue purchased an automobile identical to Tom's from Coyote. The price Sue pays is equal to Coyote's cost of the automobile ($13,500). Tom and Sue each receive a salary of $40,000 per year. Considering only the above information, do Tom and Sue have equal ability to pay income taxes for the year, and does equitable treatment occur? If not, how should the tax law be changed to produce equitable treatment?

ISSUE ID

12. **LO.2** Several of Egret Company's employees have asked the company to create a hiking trail that employees could use during their lunch hours. The company owns vacant land that is being held for future expansion, but would have to spend approximately $50,000 if it were to make a trail. Nonemployees would be allowed to use the facility as part of the company's effort to build strong community support. What are the relevant tax issues for the employees?

13. **LO.2** Redbird, Inc., does not provide its employees with any tax-exempt fringe benefits. The company is considering adopting a hospital and medical benefits insurance plan that will cost approximately $7,000 per employee. In order to adopt this plan, the company may have to reduce salaries and/or lower future salary increases. Redbird is in the 35% (combined Federal and state rates) income tax bracket. Redbird is also responsible for matching the Social Security and Medicare taxes withheld on employees' salaries. The benefits insurance plans will not be subject to the Social Security and Medicare taxes. The employees generally fall into three marginal tax rate groups:

Income Tax	Social Security and Medicare Tax	Total
.15	.0765	.2265
.25	.0765	.3265
.35	.0145	.3645

The company has asked you to assist in its financial planning for the benefits insurance plan by computing the following:

a. How much taxable compensation is the equivalent to $7,000 of exempt compensation for each of the three classes of employees?
b. What is the company's after-tax cost of the taxable compensation computed in (a) above?
c. What is the company's after-tax cost of the exempt compensation?
d. Briefly explain your conclusions from the above analysis.

14. **LO.2** George is a U.S. citizen who is employed by Hawk Enterprises, a global company. Beginning on June 1, 2010, George began working in London. He worked there until January 31, 2011, when he transferred to Paris. He worked in Paris the remainder of 2011. His salary for the first five months of 2010 was $100,000, and it was earned in the United States. His salary for the remainder of 2010 was $175,000, and it was earned in London. George's 2011 salary from Hawk was $300,000, with part being earned in London and part being earned in Paris. What is George's gross income in 2010 and 2011 (assume the 2011 indexed amount is the same as the 2010 indexed amount)?

15. **LO.3** Marvin is employed by an accounting firm and uses his automobile in connection with his work. During the month of October 2010, he works at the office for 5 days and participates in the audit of a key client for 15 days. In the audit situation, Marvin goes directly from his home to the client's office. On all other days, he drives to his employer's office. On five Saturdays in October, he drives from his home to a local university where he attends classes in a part-time MBA program. Relevant mileage is as follows:

Home to office	10 miles
Office to audit client	14 miles
Home to audit client	8 miles
Home to university	15 miles

Using the automatic mileage method, what is Marvin's deduction for the month?

16. **LO.3** Larry went from Cleveland to New York on business. His time was spent as follows:

Thursday	Travel
Friday	Business
Saturday and Sunday	Sightseeing
Monday and Tuesday	Business
Wednesday	Travel

During the trip, Larry incurred and paid expenses of $180 per day for lodging from Thursday night through Tuesday night and $110 per day for meals from Friday through Tuesday. Round-trip airfare was $400. Larry is a self-employed attorney who practices law in Cleveland.

a. How much can Larry deduct for the New York trip?
b. How will any deduction be classified?

17. **LO.3** In June of this year, Dr. and Mrs. Alvin Lord traveled to Memphis to attend a three-day conference sponsored by the American Society of Implant Dentistry. Alvin, a practicing oral surgeon, participated in scheduled technical sessions dealing with the latest developments in surgical procedures. On two days, Mrs. Lord attended group meetings where various aspects of family tax planning were discussed. On the other day, she went sightseeing. Mrs. Lord does not work for her husband, but she does their tax returns and handles the family investments. Expenses incurred in connection with the conference are summarized below:

Airfare (two tickets)	$1,040
Lodging (single and double occupancy are the same rate—$220 each day)	660
Meals ($200 × 3 days)*	600
Conference registration fee (includes $120 for Family Tax Planning sessions)	520
Car rental	240

*Split equally between Dr. and Mrs. Lord.

How much, if any, of these expenses can the Lords deduct?

18. **LO.3** On Thursday, Justin flies from Baltimore (his home office) to Cadiz (Spain). He conducts business on Friday and Tuesday; vacations on Saturday, Sunday, and Monday (a legal holiday in Spain); and returns to Baltimore on Thursday. Justin was scheduled to return home on Wednesday, but all flights were canceled due to bad weather. Therefore, he spent Wednesday watching floor shows at a local casino.

a. For tax purposes, what portion of Justin's trip is regarded as being for business?
b. Suppose Monday had not been a legal holiday. Would this change your answer to part (a)?
c. Under either (a) or (b), how much of Justin's airfare qualifies as a deductible business expense?

ETHICS AND EQUITY

19. **LO.3** Veronica is a key employee of Perdiz Corporation, an aerospace engineering concern located in Seattle. Perdiz would like to establish an office on the east coast of Florida and wants Veronica to be in charge of the branch. Veronica is hesitant about making the move because she fears she will have to sell her residence in Seattle at a loss. Perdiz buys the house from Veronica for $420,000, its cost to her. She has owned and occupied the house as her principal residence for eight years. One year later, Perdiz resells the property for $370,000. Nothing regarding the sale of the residence is ever reflected on Veronica's income tax returns. Needless to say, Perdiz absorbs all of Veronica's moving expenses. Do you have any qualms as to the way these matters have been handled for income tax purposes?

20. **LO.3** Upon losing his job as a plant manager in Quincy, Massachusetts, Anthony incurs $6,200 in job search expenses. Having no success in finding new employment in the same type of work, Anthony moves to Clearwater, Florida, and begins a charter boat business. His expenses in connection with the move are summarized below:

Penalty for breaking lease on Quincy rented residence	$2,800
Forfeiture of membership in Quincy Country Club	2,200
Packing and moving van charges	7,100
Lodging during move (3 nights)	380
Meals during move	360
Mileage (for two automobiles)	2,400 miles

How much of these expenses may Anthony deduct?

ISSUE ID

21. **LO.3** Charles is employed as a full-time high school teacher. The school district for which he works recently instituted a policy requiring all of its teachers to start working on a master's degree. Pursuant to this new rule, Charles spent most of the summer of the current year taking graduate courses at an out-of-town university. His expenses are as follows:

Tuition	$6,200
Books and course materials	1,200
Lodging	1,400
Meals	2,100
Laundry and dry cleaning	180
Campus parking	200

In addition, Charles drove his personal automobile 1,800 miles in connection with the education. He uses the automatic mileage method.

a. How much, if any, of these expenses might qualify as a deduction *for* AGI?
b. How much, if any, of these expenses might qualify as a deduction *from* AGI?

ISSUE ID

22. **LO.3** In each of the following independent situations, determine how much, if any, qualifies as a deduction *for* AGI under § 222 (qualified tuition and related expenses):
   a. Sophia is single and is employed as an architect. During the current year, she spent $3,900 in tuition to attend law school at night. Her AGI is $64,000.
   b. John is single and is employed as a pharmacist. During the current year, he spent $2,300 ($2,100 for tuition and $200 for books) to take a course in herbal supplements at a local university. His AGI is $70,000.
   c. Hailey is married and is employed as a bookkeeper. She spends $5,200 for tuition and $900 for books and supplies pursuing a bachelor's degree in accounting. Her AGI is $40,000 on the separate return she files.
   d. How much, if any, of the above amounts *not allowed under § 222* might otherwise qualify as a deduction *from* AGI?

23. **LO.3, 4** Elvis is a salesman who works for Crane Sales, Inc. Typically, Elvis spends several days out of town each week. Crane provides Elvis with a travel allowance of $1,100 per month, but requires no accountability. For the current year, Elvis had the following job-related travel expenses:

Meals	$ 5,040
Lodging	10,080
Transportation	1,400

a. What amount qualifies as a deductible travel expense?
b. What is the classification of any such deduction?

24. **LO.5** Christine is employed full-time as an accountant for a national hardware chain. She also has a private consulting practice, which provides tax advice and financial planning to the general public. For this purpose, she maintains an office in her home. Expenses relating to her home are as follows:

Real property taxes	$3,900
Interest on home mortgage	4,000
Operating expenses of home	1,100
Depreciation allocated to 20% business use	1,600

Christine's income from consulting is $16,000, and the related expenses are $5,000.

a. What is Christine's office in the home deduction?
b. Suppose that Christine also spends $3,000 to repaint and to replace the carpet in the office. How do these additional costs change the answer to part (a)?
c. Suppose Christine's income from consulting is only $8,000 (not $16,000). How does this change the answer to part (a)?

25. **LO.3, 4** Tim has AGI of $92,000 during the year and the following expenses related to his employment:

Lodging while in travel status	$4,000
Meals during travel	3,800
Business transportation	5,200
Entertainment of clients	3,600
Professional dues and subscriptions	1,000

Tim is reimbursed $13,000 under his employer's accountable plan. What are Tim's deductions *for* and *from* AGI?

26. **LO.4** Molly, age 29, is unmarried and is an active participant in a qualified deductible (traditional) IRA plan. Her modified AGI is $61,000 in 2010.
    a. Calculate the amount that Molly can contribute to the IRA and the amount she can deduct.
    b. Assume instead that Molly is a participant in a SIMPLE IRA and that her compensation for the year is $61,000. Molly elects to contribute 4% of her compensation to the account, while her employer contributes 3%. What amount will be contributed for 2010? What amount will be vested?

27. **LO.4** Karli and Jacob, ages 34 and 35, have been married for 12 years and are both active participants in employer qualified retirement plans. Their total AGI in 2010 is $174,000, and they earn salaries of $85,000 and $88,000, respectively.
    a. What amount can Karli and Jacob contribute to traditional IRAs?
    b. What amount can Karli and Jacob deduct for their contributions in (a)?
    c. What amount can Karli and Jacob contribute to Roth IRAs?
    d. What amount can Karli and Jacob deduct for their contributions in (c)?
    e. What amount can they contribute to Coverdell Education Savings Accounts for their two children?

28. **LO.4** Monica, age 51, has a traditional deductible IRA with an account balance of $102,000. Of this amount, $72,000 represents contributions, and $30,000 represents earnings. In 2010, she converts her IRA into a Roth IRA. What amount must Monica include in her gross income in 2010?

29. **LO.4** In 2013, Joyce receives a $4,000 distribution from her Coverdell Education Savings Account (CESA), which has a fair market value of $10,000. Total contributions to her CESA have been $7,000. Joyce's AGI is $25,000.
    a. Joyce uses the entire $4,000 to pay for qualified education expenses. What amount should she include in her gross income?
    b. Assume instead that Joyce uses only $2,500 of the $4,000 distribution for qualified education expenses. What amount should she include in her gross income?

30. **LO.5** In 2010, Susan's sole proprietorship earns $260,000 of self-employment net income (after the deduction for one-half of self-employment tax).
    a. Calculate the maximum amount that Susan can deduct for contributions to a defined contribution Keogh plan.
    b. Suppose Susan contributes more than the allowable amount to the Keogh plan. What are the tax consequences to her?
    c. Can Susan retire and begin receiving Keogh payments at age 55 without incurring a penalty?

31. **LO.5** Harvey is a self-employed accountant with earned income from the business of $136,050 (after the deduction for one-half of his self-employment tax). He has a profit sharing plan (e.g., defined contribution Keogh plan). What is the maximum amount Harvey can contribute to his retirement plan in 2010?

CRITICAL THINKING

32. **LO.5** In each of the following *independent* situations, determine the amount of FICA (Social Security and Medicare) that should be withheld from the employee's 2010 salary by the employer.
    a. Harry earns a $50,000 salary, files a joint return, and claims four withholding allowances.
    b. Hazel earns a $110,000 salary, files a joint return, and claims four withholding allowances.
    c. Tracey earns a $190,000 salary, files a joint return, and claims four withholding allowances.
    d. Alicia's 17-year-old son, Carlos, earns $10,000 at the family sole proprietorship.

CRITICAL THINKING

33. **LO.5** During 2010, Helen, the owner of a store, has the following income and expenses:

Gross profit on sales	$73,000
Income from part-time job (subject to FICA)	45,000
Business expenses (related to store)	15,000
Fire loss on store building	2,200
Dividend income	200
Long-term capital gain on the sale of a stock investment	2,000

Compute Helen's self-employment tax and allowable income tax deduction for the self-employment tax paid.

34. **LO.6** Hank is single and a doctor in a west Texas community. He owns and operates a cattle ranch, which has been profitable in only one of the last 10 years. He believes that he satisfies one-third of the nine factors that the IRS uses to determine whether an activity is profit seeking or a hobby. Without regard to this activity, Hank's AGI is $225,000. His only other itemized deductions are $4,000 of property taxes on his residence and $3,500 of charitable contributions. The ranch produces the following revenues and expenses in 2010:

Revenues	$31,000
Mortgage interest on barn	9,000
Property taxes on barn and land	7,500
Cattle feed	14,000
Hay	4,725
Maintenance on barn	3,000
Depreciation on barn	2,950

a. Is Hank's cattle ranch profit seeking or a hobby? Explain the probabilities.
b. Determine Hank's taxable income if the ranch is a hobby.
c. Determine his taxable income if the ranch is a business.

COMPREHENSIVE TAX RETURN PROBLEMS

TAX RETURN PROBLEM

H&R BLOCK At Home

35. Beth R. Jordan lives at 2322 Skyview Road, Mesa, AZ 85201. She is a tax accountant with Mesa Manufacturing Company, 1203 Western Avenue, Mesa, AZ 85201 (employer identification number 11–1111111). She also writes computer software programs for tax practitioners and has a part-time tax practice. Beth is single and has no dependents. Beth's birthday is July 4, 1971, and her Social Security number is 123–45–6789. She wants to contribute $3 to the Presidential Election Campaign Fund.

The following information is shown on Beth's Wage and Tax Statement (Form W–2) for 2009.

Line	Description	Amount
1	Wages, tips, other compensation	$63,000.00
2	Federal income tax withheld	10,500.00
3	Social Security wages	63,000.00
4	Social Security tax withheld	3,906.00
5	Medicare wages and tips	63,000.00
6	Medicare tax withheld	913.50
15	State	Arizona
16	State wages, tips, etc.	63,000.00
17	State income tax withheld	1,650.00

During 2009, Beth received interest of $1,300 from Arizona Federal Savings and Loan and $400 from Arizona State Bank. Each financial institution reported the interest income on a Form 1099–INT. She received qualified dividends of $800 from Blue Corporation, $750 from Green Corporation, and $650 from Orange Corporation. Each corporation reported Beth's dividend payments on a Form 1099–DIV.

Beth received a $1,100 income tax refund from the state of Arizona on April 29, 2009. On her 2008 Federal income tax return, she reported total itemized deductions of $8,200, which included $2,200 of state income tax withheld by her employer.

Fees earned from her part-time tax practice in 2009 totaled $3,800. She paid $600 to have the tax returns processed by a computerized tax return service.

On February 8, 2009, Beth bought 500 shares of Gray Corporation common stock for $17.60 a share. On September 12, she sold the stock for $14 a share.

Beth bought a used sports utility vehicle for $6,000 on June 5, 2009. She purchased the vehicle from her brother-in-law, who was unemployed and was in need of cash. On November 2, 2009, she sold the vehicle to a friend for $6,500.

On January 2, 2009, she acquired 100 shares of Blue Corporation common stock for $30 a share. She sold the stock on December 19, 2009, for $55 a share.

During 2009, Beth received royalties of $16,000 on a software program she had written. She incurred the following expenditures in connection with her software-writing activities:

Cost of personal computer (100% business use)	$7,000
Cost of printer (100% business use)	2,000
Office furniture	3,000
Supplies	650
Fee paid to computer consultant	3,500

Beth elected to expense the maximum portion of the cost of the computer, printer, and furniture allowed under the provisions of § 179. This equipment and furniture were placed in service on January 15, 2009.

Although her employer suggested that Beth attend a convention on current developments in corporate taxation, she was not reimbursed for the travel expenses of $1,420 she incurred in attending the convention. The $1,420 included $200 for the cost of meals.

During 2009, Beth paid $300 for prescription medicines and $2,875 in doctor bills, hospital bills, and medical insurance premiums. Beth paid real property taxes of $1,766 on her home. Interest on her home mortgage was $3,845, and interest to credit card companies was $320. She contributed $30 each week to her church and $10 each week to the United Way. Professional dues and subscriptions totaled $350. Beth maintained her sales tax receipts. The total is $1,954. Beth paid estimated Federal income taxes of $1,000.

Part 1—Tax Computation

Compute the net tax payable or refund due for Beth R. Jordan for 2009. If you use tax forms for your solution, you will need Forms 1040, 2106-EZ, and 4562 and Schedules A, B, C, D, and SE. Suggested software: H&R BLOCK At Home.

Part 2—Tax Planning

Beth is anticipating significant changes in her life in 2010, and she has asked you to estimate her taxable income and tax liability for 2010. She just received word that she has been qualified to adopt a two-year-old daughter. Beth expects the adoption will be finalized in 2010 and that she will incur approximately $2,000 of adoption expenses. In addition, she expects to incur approximately $3,500 of child and dependent care expenses relating to the care of her new daughter, which will enable her to keep her job at Mesa Manufacturing Company. However, with the additional demands on her time because of her daughter, she has decided to discontinue her two part-time jobs (i.e., the part-time tax practice and her software business), and she will cease making estimated income tax payments. In your computations, assume all other income and expenditures will remain at approximately the same levels as in 2009.

36. Brent A. Hart is single, age 34, and lives in a rented town home at 4621 Mockingbird Lane, Little Rock, AR. He furnishes all of the support of his widowed mother, Mildred S. Hart, age 61, who lives with him. **TAX COMPUTATION PROBLEM**

Brent is employed as a regional manager by Sports World (SW), a national chain of sporting goods retail outlets. He is paid an annual salary of $62,000 and an expense allowance (for travel and entertainment) of $24,000. He is to use the allowance to travel to the sales outlets in his region (i.e., Arkansas, Tennessee, and Mississippi) and visit and entertain key persons (e.g., store managers, landlords, suppliers, potential management-level hires). SW does not require Brent to render an accounting of his

expenses. Since SW has no administrative facilities in Little Rock, Brent is expected to maintain an office in his home.

- Brent uses his automobile 80% for business and 20% for personal purposes. He purchased the Mercury Sable in 2008 for $28,000—no trade-in allowance was involved. Depreciation has been claimed under the MACRS 200% declining-balance method, and no § 179 election was made and the taxpayer elected not to take first-year additional depreciation in the year of purchase. (For depreciation information, see the tables in Chapter 5 of the text and the IRS Instructions to Form 4562, Part V.) During 2010, the car was driven 19,000 miles. Expenses relating to the car are:

Gasoline, oil, lubrication	$4,100
Repairs and maintenance (including $500 for new tires)	900
Auto club dues, GPS fees	280
Parking ($480) and tolls ($120), *all* during business use	600
Insurance	2,800
Traffic fines ($150 during business use)	250

- Of the 2,000 square feet of living space in Brent's town home, 400 square feet (i.e. 20%) is used as an office in the home. *Total* expenses in connection with the home are summarized below:

Rent	$7,200
Utilities	3,600
Maid service (provided by a janitorial service agency)	1,800
Renter's insurance	1,300

- Brent's employment-related expenses are as follows:

Airfare	$3,100
Meals	2,800
Lodging	2,900
Entertainment (business lunches)	1,800
Car rentals	310
Business gifts	600
Trade journals	120

The business gifts consist of $30 gift certificates to a restaurant chain sent to each of 20 store managers as a Christmas present.

- Besides those items already mentioned, Brent had the following expenditures for 2010:

Medical insurance premiums (portion paid by employee)	$1,200
Medical and dental expenses not covered by insurance	6,400
Contribution to traditional IRA	5,000
Federal income tax withholdings	8,000
Arkansas income tax withholdings	3,100
Fee for preparation of 2009 income tax returns	420

- SW sponsors a contributory high-deductible health insurance plan for its employees but does not provide a retirement program.
- Receipts for 2010 not previously noted include:

Interest income—		
Capital One CD	$800	
IBM corporate bonds	300	
City of Hot Springs (AR) bonds	400	$1,500
Income tax refunds (received in 2010 but relating to 2009 returns)—		
Federal	$210	
State of Arkansas	170	380

Brent itemized his deductions in 2009. His Social Security number is 123–45–6789, and Mildred's is 123–45–6781. Mildred has no gross income for 2010.

Using the Tax Rate Schedules, determine Brent's Federal income tax payable (or refund) for 2010.

Bridge DISCIPLINE

1. Justin performs services for Partridge, Inc., and receives compensation of $85,000 for the year. Determine the tax consequences of Social Security and Medicare on Justin's take-home pay if:
   a. Justin is classified as an employee of Partridge.
   b. Justin is classified as an independent contractor.

2. Amanda has been an employee of Robin, Inc., for almost 5 years. She is a participant in Robin's defined contribution pension plan (money purchase plan). The total contributions made by Robin to the money purchase plan for Amanda are $60,000, and the balance in Amanda's account is $89,000. Amanda is considering accepting a job with a competitor of Robin's at an annual salary $7,000 higher than that received from Robin. Her boss, who is trying to convince her to stay, points out that she will not be vested in the money purchase plan until she has been employed by Robin for at least five years. In addition, she will have to start a new vesting schedule with the competitor.
   a. What is vesting, and how does it affect Amanda and her decision based on the information provided?
   b. What have been the tax consequences to Amanda of Robin's annual contribution of $16,500 to its money purchase plan for her?
   c. What effect would it have on Amanda's decision if the competitor does not provide retirement benefits?

3. The Code contains provisions that are "friendly" to specific groups of taxpayers. Among these are the following:
   - Seniors.
   - Married taxpayers.
   - Employed taxpayers.
   - Taxpayers with children.
   - Self-employed individuals.

   Provide justification for the special treatment for each of the above groups, and give an example of such special treatment for each group.

RESEARCH PROBLEMS

Note: Solutions to Research Problems can be prepared by using the **Checkpoint® Student Edition** online research product, which is available to accompany this text. It is also possible to prepare solutions to the Research Problems by using tax research materials found in a standard tax library.

THOMSON REUTERS
Checkpoint® Student Edition

COMMUNICATIONS

Research Problem 1. Tom Roberts, a chemical engineer, is a long-time employee of Teal Chemical Corporation. Tom's specialty is the design and construction of special-purpose chemical processing plants. Teal has decided to expand its presence in France and plans to transfer Tom to Paris on a three-year assignment. The planned foreign assignment will take Tom to age 65, Teal's normal retirement age.

Tom has been advised regarding the major income tax ramifications of working abroad. He has not, however, been told about the treatment of moving expenses. Since Teal Corporation pays its employees a substantial foreign service salary increment, it reimburses for moving expenses. In connection with the move, Tom plans to sell his residence and place most of his furniture in storage. Probabilities are good that the sale of the residence will result in a loss.

a. Write a letter to Tom regarding the income tax treatment of his moving expenses. Tom's address is 1389 Wilson Drive, Trent, NJ 08102. Be sure to include in the discussion the move from France back to the United States.
b. Prepare a memo for your firm's client files.

COMMUNICATIONS

Research Problem 2. Rick Beam has been an independent sales representative for various textile manufacturers for many years. His products consist of soft goods, such as tablecloths, curtains, and drapes. Rick's customers are clothing store chains, department

stores, and smaller specialty stores. The employees of these companies who are responsible for purchasing merchandise are known as buyers. These companies generally prohibit their buyers from accepting gifts from manufacturers' sales representatives.

Each year Rick gives cash gifts (never more than $25) to most of the buyers who are his customers. Generally, he cashes a large check in November and gives the money personally to the buyers around Christmas. Rick says, "This is one of the ways that I maintain my relationship with my buyers." He maintains adequate substantiation of all the gifts.

Rick's deductions for these gifts have been disallowed by the IRS, based on § 162(c)(2). Rick is confused and comes to you, a CPA, for advice.

a. Write a letter to Rick concerning his tax position on this issue. Rick's address is 948 Octavia Street, New Orleans, LA 70113.
b. Prepare a memo for your files supporting the advice you have given.

Research Problem 3. In which, if either, of the following independent situations is the taxpayer "away from home" so as to permit a deduction for the cost of meals obtained during the trip?

- *Case A.* Ryan is the sales representative for a national greeting card company. As he has a rather extensive sales territory, Ryan makes his rounds using a company-owned car over a 16- to 19-hour period. During these one-day business trips, Ryan will pull over to a roadside park at least once and take a short nap in the backseat of his auto.
- *Case B.* Matthew is the captain of a ferryboat that carries several hundred tourists on round trips from Seattle to Victoria and back. Each voyage lasts from 15 to 17 hours and provides for a 6- to 7-hour layover in Victoria, enabling the passengers to shop and sightsee. During the layover, Matthew usually takes a 4-hour nap on a cot located in the pilothouse of the ferryboat.

Partial list of research aids:
§ 162(a)(2).
Rev.Rul. 61–221, 1961–2 C.B. 34.
Frederick J. Barry, 54 T.C. 1210 (1970), *aff'd* in 71–USTC ¶9126, 27 AFTR 2d 71–334, 435 F.2d 1290 (CA–1, 1970).
Marc G. Bissonnette, 127 T.C. 124 (2006).

Research Problem 4. Herron, Inc., previously gave all of its employees a ham for Christmas. However, many of the employees do not eat ham. Therefore, Herron has decided to give each employee a coupon for $35 that can be redeemed (for food or cash) any time between December 1 and January 31 of the following year. Herron has asked you whether the coupons can be excluded from the employees' gross income as a *de minimis* fringe benefit.

Research Problem 5. You recently read an article in your school newspaper about Professor Rodney Taylor, one of your favorite professors in the religious studies department. According to the article, he and the university have been negotiating an early retirement package and have reached a stumbling block. Under the agreement, Professor Taylor is to receive a lump-sum payment equal to one year's salary in exchange for his retirement and the release of any and all rights associated with his tenure status. While recognizing that the payment would be subject to income tax, Taylor contends that the amount is not earned income and thus should not be subject to the FICA tax. The university negotiators say that they are not aware of any authority that supports Taylor's view. In fact, they have learned that other universities in the state system have been withholding amounts for FICA for years in situations involving early retirement buyout packages for high-level administrators. The university's position is that lacking the authority to not withhold for FICA and given the precedent of similar early retirement packages at other universities, they are obligated to withhold FICA from the payment. You want to come to the aid of Professor Taylor. Obviously, if the payments are considered wages subject to the FICA tax, the value of the offer to Professor Taylor will be significantly reduced. Can you find any authority for his position?

Research Problem 6. Kristina will soon graduate from law school with more than $40,000 in student loans. She would like to work as a public defender, but the pay is not enough to allow her to meet her living expenses and repay the student loans. Her law school offers a "debt forgiveness program" for graduates who enter public service, including working as a public defender. Under the program, the school will pay the student's debt, but the graduate will owe an equal amount to the program. However, if the graduate remains in

public service for at least four years, the debt is forgiven. Kristina would like to know the tax consequences if she decides to utilize this program.



Use the tax resources of the Internet to address the following questions. Do not restrict your search to the Web, but include a review of newsgroups and general reference materials, practitioner sites and resources, primary sources of the tax law, chat rooms and discussion groups, and other opportunities.

Research Problem 7. An employer allows its employees limited personal use of one of the corporate executive jets. Does the IRS provide any guidelines as to how much income the employee should recognize due to such use?

Research Problem 8. Check with a major CPA firm in your area. Does the firm provide office space for all of its field auditors? If so, what arrangements are made? If not, what workplace does the firm expect the staff to use?

Appendix A

TAX RATE SCHEDULES AND TABLES

(The 2010 Tax Tables and 2010 Sales Tax Tables can be accessed at the IRS website: [**www.irs.gov**] when released.)

2009 Income Tax Rate Schedules	A-2
2010 Income Tax Rate Schedules	A-2
2009 Tax Table	A-3
Income Tax Rates—Estates and Trusts	A-15
Income Tax Rates—Corporations	A-15
Unified Transfer Tax Rates (For Gifts Made and Deaths After 1983 and Before 2002)	A-16
Unified Transfer Tax Rates (For Gifts Made and Deaths in 2002)	A-16
Unified Transfer Tax Rates (For Gifts Made and Deaths in 2003–2006)	A-17
Unified Transfer Tax Rates (For Gifts Made and Deaths in 2007–2009)	A-18
2009 Optional Sales Tax Tables	A-19

2009 Tax Rate Schedules

Single—Schedule X

If taxable income is: Over—	But not over—	The tax is:	of the amount over—
$ 0	$ 8,350	.....10%	$ 0
8,350	33,950	$ 835.00 + 15%	8,350
33,950	82,250	4,675.00 + 25%	33,950
82,250	171,550	16,750.00 + 28%	82,250
171,550	372,950	41,754.00 + 33%	171,550
372,950	.....	108,216.00 + 35%	372,950

Head of household—Schedule Z

If taxable income is: Over—	But not over—	The tax is:	of the amount over—
$ 0	$ 11,950	.....10%	$ 0
11,950	45,500	$ 1,195.00 + 15%	11,950
45,500	117,450	6,227.50 + 25%	45,500
117,450	190,200	24,215.00 + 28%	117,450
190,200	372,950	44,585.00 + 33%	190,200
372,950	.....	104,892.50 + 35%	372,950

Married filing jointly or Qualifying widow(er)—Schedule Y–1

If taxable income is: Over—	But not over—	The tax is:	of the amount over—
$ 0	$ 16,700	.....10%	$ 0
16,700	67,900	$ 1,670.00 + 15%	16,700
67,900	137,050	9,350.00 + 25%	67,900
137,050	208,850	26,637.50 + 28%	137,050
208,850	372,950	46,741.50 + 33%	208,850
372,950	.....	100,894.50 + 35%	372,950

Married filing separately—Schedule Y–2

If taxable income is: Over—	But not over—	The tax is:	of the amount over—
$ 0	$ 8,350	.....10%	$ 0
8,350	33,950	$ 835.00 + 15%	8,350
33,950	68,525	4,675.00 + 25%	33,950
68,525	104,425	13,318.75 + 28%	68,525
104,425	186,475	23,370.75 + 33%	104,425
186,475	.....	50,447.25 + 35%	186,475

2010 Tax Rate Schedules

Single—Schedule X

If taxable income is: Over—	But not over—	The tax is:	of the amount over—
$ 0	$ 8,375	.....10%	$ 0
8,375	34,000	$ 837.50 + 15%	8,375
34,000	82,400	4,681.25 + 25%	34,000
82,400	171,850	16,781.25 + 28%	82,400
171,850	373,650	41,827.25 + 33%	171,850
373,650	.....	108,421.25 + 35%	373,650

Head of household—Schedule Z

If taxable income is: Over—	But not over—	The tax is:	of the amount over—
$ 0	$ 11,950	.....10%	$ 0
11,950	45,550	$ 1,195.00 + 15%	11,950
45,550	117,650	6,235.00 + 25%	45,550
117,650	190,550	24,260.00 + 28%	117,650
190,550	373,650	44,672.00 + 33%	190,550
373,650	.....	105,095.00 + 35%	373,650

Married filing jointly or Qualifying widow(er)—Schedule Y–1

If taxable income is: Over—	But not over—	The tax is:	of the amount over—
$ 0	$ 16,750	.....10%	$ 0
16,750	68,000	$ 1,675.00 + 15%	16,750
68,000	137,300	9,362.50 + 25%	68,000
137,300	209,250	26,687.50 + 28%	137,300
209,250	373,650	46,833.50 + 33%	209,250
373,650	.....	101,085.50 + 35%	373,650

Married filing separately—Schedule Y–2

If taxable income is: Over—	But not over—	The tax is:	of the amount over—
$ 0	$ 8,375	.....10%	$ 0
8,375	34,000	$ 837.50 + 15%	8,375
34,000	68,650	4,681.25 + 25%	34,000
68,650	104,625	13,343.75 + 28%	68,650
104,625	186,825	23,416.75 + 33%	104,625
186,825	.....	50,542.75 + 35%	186,825

2009 Tax Table

CAUTION *See the instructions for line 44 that begin on page 37 to see if you must use the Tax Table below to figure your tax.*

Example. Mr. and Mrs. Brown are filing a joint return. Their taxable income on Form 1040, line 43, is $25,300. First, they find the $25,300–25,350 taxable income line. Next, they find the column for married filing jointly and read down the column. The amount shown where the taxable income line and filing status column meet is $2,964. This is the tax amount they should enter on Form 1040, line 44.

Sample Table

At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—			
25,200	25,250	3,366	2,949	3,366	3,186
25,250	25,300	3,374	2,956	3,374	3,194
25,300	25,350	3,381	2,964	3,381	3,201
25,350	25,400	3,389	2,971	3,389	3,209

If line 43 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—			
0	5	0	0	0	0
5	15	1	1	1	1
15	25	2	2	2	2
25	50	4	4	4	4
50	75	6	6	6	6
75	100	9	9	9	9
100	125	11	11	11	11
125	150	14	14	14	14
150	175	16	16	16	16
175	200	19	19	19	19
200	225	21	21	21	21
225	250	24	24	24	24
250	275	26	26	26	26
275	300	29	29	29	29
300	325	31	31	31	31
325	350	34	34	34	34
350	375	36	36	36	36
375	400	39	39	39	39
400	425	41	41	41	41
425	450	44	44	44	44
450	475	46	46	46	46
475	500	49	49	49	49
500	525	51	51	51	51
525	550	54	54	54	54
550	575	56	56	56	56
575	600	59	59	59	59
600	625	61	61	61	61
625	650	64	64	64	64
650	675	66	66	66	66
675	700	69	69	69	69
700	725	71	71	71	71
725	750	74	74	74	74
750	775	76	76	76	76
775	800	79	79	79	79
800	825	81	81	81	81
825	850	84	84	84	84
850	875	86	86	86	86
875	900	89	89	89	89
900	925	91	91	91	91
925	950	94	94	94	94
950	975	96	96	96	96
975	1,000	99	99	99	99
1,000					
1,000	1,025	101	101	101	101
1,025	1,050	104	104	104	104
1,050	1,075	106	106	106	106
1,075	1,100	109	109	109	109
1,100	1,125	111	111	111	111
1,125	1,150	114	114	114	114
1,150	1,175	116	116	116	116
1,175	1,200	119	119	119	119
1,200	1,225	121	121	121	121
1,225	1,250	124	124	124	124
1,250	1,275	126	126	126	126
1,275	1,300	129	129	129	129
1,300	1,325	131	131	131	131
1,325	1,350	134	134	134	134
1,350	1,375	136	136	136	136
1,375	1,400	139	139	139	139
1,400	1,425	141	141	141	141
1,425	1,450	144	144	144	144
1,450	1,475	146	146	146	146
1,475	1,500	149	149	149	149
1,500	1,525	151	151	151	151
1,525	1,550	154	154	154	154
1,550	1,575	156	156	156	156
1,575	1,600	159	159	159	159
1,600	1,625	161	161	161	161
1,625	1,650	164	164	164	164
1,650	1,675	166	166	166	166
1,675	1,700	169	169	169	169
1,700	1,725	171	171	171	171
1,725	1,750	174	174	174	174
1,750	1,775	176	176	176	176
1,775	1,800	179	179	179	179
1,800	1,825	181	181	181	181
1,825	1,850	184	184	184	184
1,850	1,875	186	186	186	186
1,875	1,900	189	189	189	189
1,900	1,925	191	191	191	191
1,925	1,950	194	194	194	194
1,950	1,975	196	196	196	196
1,975	2,000	199	199	199	199
2,000					
2,000	2,025	201	201	201	201
2,025	2,050	204	204	204	204
2,050	2,075	206	206	206	206
2,075	2,100	209	209	209	209
2,100	2,125	211	211	211	211
2,125	2,150	214	214	214	214
2,150	2,175	216	216	216	216
2,175	2,200	219	219	219	219
2,200	2,225	221	221	221	221
2,225	2,250	224	224	224	224
2,250	2,275	226	226	226	226
2,275	2,300	229	229	229	229
2,300	2,325	231	231	231	231
2,325	2,350	234	234	234	234
2,350	2,375	236	236	236	236
2,375	2,400	239	239	239	239
2,400	2,425	241	241	241	241
2,425	2,450	244	244	244	244
2,450	2,475	246	246	246	246
2,475	2,500	249	249	249	249
2,500	2,525	251	251	251	251
2,525	2,550	254	254	254	254
2,550	2,575	256	256	256	256
2,575	2,600	259	259	259	259
2,600	2,625	261	261	261	261
2,625	2,650	264	264	264	264
2,650	2,675	266	266	266	266
2,675	2,700	269	269	269	269
2,700	2,725	271	271	271	271
2,725	2,750	274	274	274	274
2,750	2,775	276	276	276	276
2,775	2,800	279	279	279	279
2,800	2,825	281	281	281	281
2,825	2,850	284	284	284	284
2,850	2,875	286	286	286	286
2,875	2,900	289	289	289	289
2,900	2,925	291	291	291	291
2,925	2,950	294	294	294	294
2,950	2,975	296	296	296	296
2,975	3,000	299	299	299	299
3,000					
3,000	3,050	303	303	303	303
3,050	3,100	308	308	308	308
3,100	3,150	313	313	313	313
3,150	3,200	318	318	318	318
3,200	3,250	323	323	323	323
3,250	3,300	328	328	328	328
3,300	3,350	333	333	333	333
3,350	3,400	338	338	338	338
3,400	3,450	343	343	343	343
3,450	3,500	348	348	348	348
3,500	3,550	353	353	353	353
3,550	3,600	358	358	358	358
3,600	3,650	363	363	363	363
3,650	3,700	368	368	368	368
3,700	3,750	373	373	373	373
3,750	3,800	378	378	378	378
3,800	3,850	383	383	383	383
3,850	3,900	388	388	388	388
3,900	3,950	393	393	393	393
3,950	4,000	398	398	398	398
4,000					
4,000	4,050	403	403	403	403
4,050	4,100	408	408	408	408
4,100	4,150	413	413	413	413
4,150	4,200	418	418	418	418
4,200	4,250	423	423	423	423
4,250	4,300	428	428	428	428
4,300	4,350	433	433	433	433
4,350	4,400	438	438	438	438
4,400	4,450	443	443	443	443
4,450	4,500	448	448	448	448
4,500	4,550	453	453	453	453
4,550	4,600	458	458	458	458
4,600	4,650	463	463	463	463
4,650	4,700	468	468	468	468
4,700	4,750	473	473	473	473
4,750	4,800	478	478	478	478
4,800	4,850	483	483	483	483
4,850	4,900	488	488	488	488
4,900	4,950	493	493	493	493
4,950	5,000	498	498	498	498

* This column must also be used by a qualifying widow(er).

(Continued on next page)

2009 Tax Table–*Continued*

If line 43 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—			
5,000					
5,000	5,050	503	503	503	503
5,050	5,100	508	508	508	508
5,100	5,150	513	513	513	513
5,150	5,200	518	518	518	518
5,200	5,250	523	523	523	523
5,250	5,300	528	528	528	528
5,300	5,350	533	533	533	533
5,350	5,400	538	538	538	538
5,400	5,450	543	543	543	543
5,450	5,500	548	548	548	548
5,500	5,550	553	553	553	553
5,550	5,600	558	558	558	558
5,600	5,650	563	563	563	563
5,650	5,700	568	568	568	568
5,700	5,750	573	573	573	573
5,750	5,800	578	578	578	578
5,800	5,850	583	583	583	583
5,850	5,900	588	588	588	588
5,900	5,950	593	593	593	593
5,950	6,000	598	598	598	598
6,000					
6,000	6,050	603	603	603	603
6,050	6,100	608	608	608	608
6,100	6,150	613	613	613	613
6,150	6,200	618	618	618	618
6,200	6,250	623	623	623	623
6,250	6,300	628	628	628	628
6,300	6,350	633	633	633	633
6,350	6,400	638	638	638	638
6,400	6,450	643	643	643	643
6,450	6,500	648	648	648	648
6,500	6,550	653	653	653	653
6,550	6,600	658	658	658	658
6,600	6,650	663	663	663	663
6,650	6,700	668	668	668	668
6,700	6,750	673	673	673	673
6,750	6,800	678	678	678	678
6,800	6,850	683	683	683	683
6,850	6,900	688	688	688	688
6,900	6,950	693	693	693	693
6,950	7,000	698	698	698	698
7,000					
7,000	7,050	703	703	703	703
7,050	7,100	708	708	708	708
7,100	7,150	713	713	713	713
7,150	7,200	718	718	718	718
7,200	7,250	723	723	723	723
7,250	7,300	728	728	728	728
7,300	7,350	733	733	733	733
7,350	7,400	738	738	738	738
7,400	7,450	743	743	743	743
7,450	7,500	748	748	748	748
7,500	7,550	753	753	753	753
7,550	7,600	758	758	758	758
7,600	7,650	763	763	763	763
7,650	7,700	768	768	768	768
7,700	7,750	773	773	773	773
7,750	7,800	778	778	778	778
7,800	7,850	783	783	783	783
7,850	7,900	788	788	788	788
7,900	7,950	793	793	793	793
7,950	8,000	798	798	798	798
8,000					
8,000	8,050	803	803	803	803
8,050	8,100	808	808	808	808
8,100	8,150	813	813	813	813
8,150	8,200	818	818	818	818
8,200	8,250	823	823	823	823
8,250	8,300	828	828	828	828
8,300	8,350	833	833	833	833
8,350	8,400	839	838	839	838
8,400	8,450	846	843	846	843
8,450	8,500	854	848	854	848
8,500	8,550	861	853	861	853
8,550	8,600	869	858	869	858
8,600	8,650	876	863	876	863
8,650	8,700	884	868	884	868
8,700	8,750	891	873	891	873
8,750	8,800	899	878	899	878
8,800	8,850	906	883	906	883
8,850	8,900	914	888	914	888
8,900	8,950	921	893	921	893
8,950	9,000	929	898	929	898
9,000					
9,000	9,050	936	903	936	903
9,050	9,100	944	908	944	908
9,100	9,150	951	913	951	913
9,150	9,200	959	918	959	918
9,200	9,250	966	923	966	923
9,250	9,300	974	928	974	928
9,300	9,350	981	933	981	933
9,350	9,400	989	938	989	938
9,400	9,450	996	943	996	943
9,450	9,500	1,004	948	1,004	948
9,500	9,550	1,011	953	1,011	953
9,550	9,600	1,019	958	1,019	958
9,600	9,650	1,026	963	1,026	963
9,650	9,700	1,034	968	1,034	968
9,700	9,750	1,041	973	1,041	973
9,750	9,800	1,049	978	1,049	978
9,800	9,850	1,056	983	1,056	983
9,850	9,900	1,064	988	1,064	988
9,900	9,950	1,071	993	1,071	993
9,950	10,000	1,079	998	1,079	998
10,000					
10,000	10,050	1,086	1,003	1,086	1,003
10,050	10,100	1,094	1,008	1,094	1,008
10,100	10,150	1,101	1,013	1,101	1,013
10,150	10,200	1,109	1,018	1,109	1,018
10,200	10,250	1,116	1,023	1,116	1,023
10,250	10,300	1,124	1,028	1,124	1,028
10,300	10,350	1,131	1,033	1,131	1,033
10,350	10,400	1,139	1,038	1,139	1,038
10,400	10,450	1,146	1,043	1,146	1,043
10,450	10,500	1,154	1,048	1,154	1,048
10,500	10,550	1,161	1,053	1,161	1,053
10,550	10,600	1,169	1,058	1,169	1,058
10,600	10,650	1,176	1,063	1,176	1,063
10,650	10,700	1,184	1,068	1,184	1,068
10,700	10,750	1,191	1,073	1,191	1,073
10,750	10,800	1,199	1,078	1,199	1,078
10,800	10,850	1,206	1,083	1,206	1,083
10,850	10,900	1,214	1,088	1,214	1,088
10,900	10,950	1,221	1,093	1,221	1,093
10,950	11,000	1,229	1,098	1,229	1,098
11,000					
11,000	11,050	1,236	1,103	1,236	1,103
11,050	11,100	1,244	1,108	1,244	1,108
11,100	11,150	1,251	1,113	1,251	1,113
11,150	11,200	1,259	1,118	1,259	1,118
11,200	11,250	1,266	1,123	1,266	1,123
11,250	11,300	1,274	1,128	1,274	1,128
11,300	11,350	1,281	1,133	1,281	1,133
11,350	11,400	1,289	1,138	1,289	1,138
11,400	11,450	1,296	1,143	1,296	1,143
11,450	11,500	1,304	1,148	1,304	1,148
11,500	11,550	1,311	1,153	1,311	1,153
11,550	11,600	1,319	1,158	1,319	1,158
11,600	11,650	1,326	1,163	1,326	1,163
11,650	11,700	1,334	1,168	1,334	1,168
11,700	11,750	1,341	1,173	1,341	1,173
11,750	11,800	1,349	1,178	1,349	1,178
11,800	11,850	1,356	1,183	1,356	1,183
11,850	11,900	1,364	1,188	1,364	1,188
11,900	11,950	1,371	1,193	1,371	1,193
11,950	12,000	1,379	1,198	1,379	1,199
12,000					
12,000	12,050	1,386	1,203	1,386	1,206
12,050	12,100	1,394	1,208	1,394	1,214
12,100	12,150	1,401	1,213	1,401	1,221
12,150	12,200	1,409	1,218	1,409	1,229
12,200	12,250	1,416	1,223	1,416	1,236
12,250	12,300	1,424	1,228	1,424	1,244
12,300	12,350	1,431	1,233	1,431	1,251
12,350	12,400	1,439	1,238	1,439	1,259
12,400	12,450	1,446	1,243	1,446	1,266
12,450	12,500	1,454	1,248	1,454	1,274
12,500	12,550	1,461	1,253	1,461	1,281
12,550	12,600	1,469	1,258	1,469	1,289
12,600	12,650	1,476	1,263	1,476	1,296
12,650	12,700	1,484	1,268	1,484	1,304
12,700	12,750	1,491	1,273	1,491	1,311
12,750	12,800	1,499	1,278	1,499	1,319
12,800	12,850	1,506	1,283	1,506	1,326
12,850	12,900	1,514	1,288	1,514	1,334
12,900	12,950	1,521	1,293	1,521	1,341
12,950	13,000	1,529	1,298	1,529	1,349
13,000					
13,000	13,050	1,536	1,303	1,536	1,356
13,050	13,100	1,544	1,308	1,544	1,364
13,100	13,150	1,551	1,313	1,551	1,371
13,150	13,200	1,559	1,318	1,559	1,379
13,200	13,250	1,566	1,323	1,566	1,386
13,250	13,300	1,574	1,328	1,574	1,394
13,300	13,350	1,581	1,333	1,581	1,401
13,350	13,400	1,589	1,338	1,589	1,409
13,400	13,450	1,596	1,343	1,596	1,416
13,450	13,500	1,604	1,348	1,604	1,424
13,500	13,550	1,611	1,353	1,611	1,431
13,550	13,600	1,619	1,358	1,619	1,439
13,600	13,650	1,626	1,363	1,626	1,446
13,650	13,700	1,634	1,368	1,634	1,454
13,700	13,750	1,641	1,373	1,641	1,461
13,750	13,800	1,649	1,378	1,649	1,469
13,800	13,850	1,656	1,383	1,656	1,476
13,850	13,900	1,664	1,388	1,664	1,484
13,900	13,950	1,671	1,393	1,671	1,491
13,950	14,000	1,679	1,398	1,679	1,499

*This column must also be used by a qualifying widow(er).

(Continued on next page)

2009 Tax Table–*Continued*

If line 43 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—			
14,000					
14,000	14,050	1,686	1,403	1,686	1,506
14,050	14,100	1,694	1,408	1,694	1,514
14,100	14,150	1,701	1,413	1,701	1,521
14,150	14,200	1,709	1,418	1,709	1,529
14,200	14,250	1,716	1,423	1,716	1,536
14,250	14,300	1,724	1,428	1,724	1,544
14,300	14,350	1,731	1,433	1,731	1,551
14,350	14,400	1,739	1,438	1,739	1,559
14,400	14,450	1,746	1,443	1,746	1,566
14,450	14,500	1,754	1,448	1,754	1,574
14,500	14,550	1,761	1,453	1,761	1,581
14,550	14,600	1,769	1,458	1,769	1,589
14,600	14,650	1,776	1,463	1,776	1,596
14,650	14,700	1,784	1,468	1,784	1,604
14,700	14,750	1,791	1,473	1,791	1,611
14,750	14,800	1,799	1,478	1,799	1,619
14,800	14,850	1,806	1,483	1,806	1,626
14,850	14,900	1,814	1,488	1,814	1,634
14,900	14,950	1,821	1,493	1,821	1,641
14,950	15,000	1,829	1,498	1,829	1,649
15,000					
15,000	15,050	1,836	1,503	1,836	1,656
15,050	15,100	1,844	1,508	1,844	1,664
15,100	15,150	1,851	1,513	1,851	1,671
15,150	15,200	1,859	1,518	1,859	1,679
15,200	15,250	1,866	1,523	1,866	1,686
15,250	15,300	1,874	1,528	1,874	1,694
15,300	15,350	1,881	1,533	1,881	1,701
15,350	15,400	1,889	1,538	1,889	1,709
15,400	15,450	1,896	1,543	1,896	1,716
15,450	15,500	1,904	1,548	1,904	1,724
15,500	15,550	1,911	1,553	1,911	1,731
15,550	15,600	1,919	1,558	1,919	1,739
15,600	15,650	1,926	1,563	1,926	1,746
15,650	15,700	1,934	1,568	1,934	1,754
15,700	15,750	1,941	1,573	1,941	1,761
15,750	15,800	1,949	1,578	1,949	1,769
15,800	15,850	1,956	1,583	1,956	1,776
15,850	15,900	1,964	1,588	1,964	1,784
15,900	15,950	1,971	1,593	1,971	1,791
15,950	16,000	1,979	1,598	1,979	1,799
16,000					
16,000	16,050	1,986	1,603	1,986	1,806
16,050	16,100	1,994	1,608	1,994	1,814
16,100	16,150	2,001	1,613	2,001	1,821
16,150	16,200	2,009	1,618	2,009	1,829
16,200	16,250	2,016	1,623	2,016	1,836
16,250	16,300	2,024	1,628	2,024	1,844
16,300	16,350	2,031	1,633	2,031	1,851
16,350	16,400	2,039	1,638	2,039	1,859
16,400	16,450	2,046	1,643	2,046	1,866
16,450	16,500	2,054	1,648	2,054	1,874
16,500	16,550	2,061	1,653	2,061	1,881
16,550	16,600	2,069	1,658	2,069	1,889
16,600	16,650	2,076	1,663	2,076	1,896
16,650	16,700	2,084	1,668	2,084	1,904
16,700	16,750	2,091	1,674	2,091	1,911
16,750	16,800	2,099	1,681	2,099	1,919
16,800	16,850	2,106	1,689	2,106	1,926
16,850	16,900	2,114	1,696	2,114	1,934
16,900	16,950	2,121	1,704	2,121	1,941
16,950	17,000	2,129	1,711	2,129	1,949
17,000					
17,000	17,050	2,136	1,719	2,136	1,956
17,050	17,100	2,144	1,726	2,144	1,964
17,100	17,150	2,151	1,734	2,151	1,971
17,150	17,200	2,159	1,741	2,159	1,979
17,200	17,250	2,166	1,749	2,166	1,986
17,250	17,300	2,174	1,756	2,174	1,994
17,300	17,350	2,181	1,764	2,181	2,001
17,350	17,400	2,189	1,771	2,189	2,009
17,400	17,450	2,196	1,779	2,196	2,016
17,450	17,500	2,204	1,786	2,204	2,024
17,500	17,550	2,211	1,794	2,211	2,031
17,550	17,600	2,219	1,801	2,219	2,039
17,600	17,650	2,226	1,809	2,226	2,046
17,650	17,700	2,234	1,816	2,234	2,054
17,700	17,750	2,241	1,824	2,241	2,061
17,750	17,800	2,249	1,831	2,249	2,069
17,800	17,850	2,256	1,839	2,256	2,076
17,850	17,900	2,264	1,846	2,264	2,084
17,900	17,950	2,271	1,854	2,271	2,091
17,950	18,000	2,279	1,861	2,279	2,099
18,000					
18,000	18,050	2,286	1,869	2,286	2,106
18,050	18,100	2,294	1,876	2,294	2,114
18,100	18,150	2,301	1,884	2,301	2,121
18,150	18,200	2,309	1,891	2,309	2,129
18,200	18,250	2,316	1,899	2,316	2,136
18,250	18,300	2,324	1,906	2,324	2,144
18,300	18,350	2,331	1,914	2,331	2,151
18,350	18,400	2,339	1,921	2,339	2,159
18,400	18,450	2,346	1,929	2,346	2,166
18,450	18,500	2,354	1,936	2,354	2,174
18,500	18,550	2,361	1,944	2,361	2,181
18,550	18,600	2,369	1,951	2,369	2,189
18,600	18,650	2,376	1,959	2,376	2,196
18,650	18,700	2,384	1,966	2,384	2,204
18,700	18,750	2,391	1,974	2,391	2,211
18,750	18,800	2,399	1,981	2,399	2,219
18,800	18,850	2,406	1,989	2,406	2,226
18,850	18,900	2,414	1,996	2,414	2,234
18,900	18,950	2,421	2,004	2,421	2,241
18,950	19,000	2,429	2,011	2,429	2,249
19,000					
19,000	19,050	2,436	2,019	2,436	2,256
19,050	19,100	2,444	2,026	2,444	2,264
19,100	19,150	2,451	2,034	2,451	2,271
19,150	19,200	2,459	2,041	2,459	2,279
19,200	19,250	2,466	2,049	2,466	2,286
19,250	19,300	2,474	2,056	2,474	2,294
19,300	19,350	2,481	2,064	2,481	2,301
19,350	19,400	2,489	2,071	2,489	2,309
19,400	19,450	2,496	2,079	2,496	2,316
19,450	19,500	2,504	2,086	2,504	2,324
19,500	19,550	2,511	2,094	2,511	2,331
19,550	19,600	2,519	2,101	2,519	2,339
19,600	19,650	2,526	2,109	2,526	2,346
19,650	19,700	2,534	2,116	2,534	2,354
19,700	19,750	2,541	2,124	2,541	2,361
19,750	19,800	2,549	2,131	2,549	2,369
19,800	19,850	2,556	2,139	2,556	2,376
19,850	19,900	2,564	2,146	2,564	2,384
19,900	19,950	2,571	2,154	2,571	2,391
19,950	20,000	2,579	2,161	2,579	2,399
20,000					
20,000	20,050	2,586	2,169	2,586	2,406
20,050	20,100	2,594	2,176	2,594	2,414
20,100	20,150	2,601	2,184	2,601	2,421
20,150	20,200	2,609	2,191	2,609	2,429
20,200	20,250	2,616	2,199	2,616	2,436
20,250	20,300	2,624	2,206	2,624	2,444
20,300	20,350	2,631	2,214	2,631	2,451
20,350	20,400	2,639	2,221	2,639	2,459
20,400	20,450	2,646	2,229	2,646	2,466
20,450	20,500	2,654	2,236	2,654	2,474
20,500	20,550	2,661	2,244	2,661	2,481
20,550	20,600	2,669	2,251	2,669	2,489
20,600	20,650	2,676	2,259	2,676	2,496
20,650	20,700	2,684	2,266	2,684	2,504
20,700	20,750	2,691	2,274	2,691	2,511
20,750	20,800	2,699	2,281	2,699	2,519
20,800	20,850	2,706	2,289	2,706	2,526
20,850	20,900	2,714	2,296	2,714	2,534
20,900	20,950	2,721	2,304	2,721	2,541
20,950	21,000	2,729	2,311	2,729	2,549
21,000					
21,000	21,050	2,736	2,319	2,736	2,556
21,050	21,100	2,744	2,326	2,744	2,564
21,100	21,150	2,751	2,334	2,751	2,571
21,150	21,200	2,759	2,341	2,759	2,579
21,200	21,250	2,766	2,349	2,766	2,586
21,250	21,300	2,774	2,356	2,774	2,594
21,300	21,350	2,781	2,364	2,781	2,601
21,350	21,400	2,789	2,371	2,789	2,609
21,400	21,450	2,796	2,379	2,796	2,616
21,450	21,500	2,804	2,386	2,804	2,624
21,500	21,550	2,811	2,394	2,811	2,631
21,550	21,600	2,819	2,401	2,819	2,639
21,600	21,650	2,826	2,409	2,826	2,646
21,650	21,700	2,834	2,416	2,834	2,654
21,700	21,750	2,841	2,424	2,841	2,661
21,750	21,800	2,849	2,431	2,849	2,669
21,800	21,850	2,856	2,439	2,856	2,676
21,850	21,900	2,864	2,446	2,864	2,684
21,900	21,950	2,871	2,454	2,871	2,691
21,950	22,000	2,879	2,461	2,879	2,699
22,000					
22,000	22,050	2,886	2,469	2,886	2,706
22,050	22,100	2,894	2,476	2,894	2,714
22,100	22,150	2,901	2,484	2,901	2,721
22,150	22,200	2,909	2,491	2,909	2,729
22,200	22,250	2,916	2,499	2,916	2,736
22,250	22,300	2,924	2,506	2,924	2,744
22,300	22,350	2,931	2,514	2,931	2,751
22,350	22,400	2,939	2,521	2,939	2,759
22,400	22,450	2,946	2,529	2,946	2,766
22,450	22,500	2,954	2,536	2,954	2,774
22,500	22,550	2,961	2,544	2,961	2,781
22,550	22,600	2,969	2,551	2,969	2,789
22,600	22,650	2,976	2,559	2,976	2,796
22,650	22,700	2,984	2,566	2,984	2,804
22,700	22,750	2,991	2,574	2,991	2,811
22,750	22,800	2,999	2,581	2,999	2,819
22,800	22,850	3,006	2,589	3,006	2,826
22,850	22,900	3,014	2,596	3,014	2,834
22,900	22,950	3,021	2,604	3,021	2,841
22,950	23,000	3,029	2,611	3,029	2,849

*This column must also be used by a qualifying widow(er).

(Continued on next page)

2009 Tax Table–*Continued*

If line 43 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—			
23,000					
23,000	23,050	3,036	2,619	3,036	2,856
23,050	23,100	3,044	2,626	3,044	2,864
23,100	23,150	3,051	2,634	3,051	2,871
23,150	23,200	3,059	2,641	3,059	2,879
23,200	23,250	3,066	2,649	3,066	2,886
23,250	23,300	3,074	2,656	3,074	2,894
23,300	23,350	3,081	2,664	3,081	2,901
23,350	23,400	3,089	2,671	3,089	2,909
23,400	23,450	3,096	2,679	3,096	2,916
23,450	23,500	3,104	2,686	3,104	2,924
23,500	23,550	3,111	2,694	3,111	2,931
23,550	23,600	3,119	2,701	3,119	2,939
23,600	23,650	3,126	2,709	3,126	2,946
23,650	23,700	3,134	2,716	3,134	2,954
23,700	23,750	3,141	2,724	3,141	2,961
23,750	23,800	3,149	2,731	3,149	2,969
23,800	23,850	3,156	2,739	3,156	2,976
23,850	23,900	3,164	2,746	3,164	2,984
23,900	23,950	3,171	2,754	3,171	2,991
23,950	24,000	3,179	2,761	3,179	2,999
24,000					
24,000	24,050	3,186	2,769	3,186	3,006
24,050	24,100	3,194	2,776	3,194	3,014
24,100	24,150	3,201	2,784	3,201	3,021
24,150	24,200	3,209	2,791	3,209	3,029
24,200	24,250	3,216	2,799	3,216	3,036
24,250	24,300	3,224	2,806	3,224	3,044
24,300	24,350	3,231	2,814	3,231	3,051
24,350	24,400	3,239	2,821	3,239	3,059
24,400	24,450	3,246	2,829	3,246	3,066
24,450	24,500	3,254	2,836	3,254	3,074
24,500	24,550	3,261	2,844	3,261	3,081
24,550	24,600	3,269	2,851	3,269	3,089
24,600	24,650	3,276	2,859	3,276	3,096
24,650	24,700	3,284	2,866	3,284	3,104
24,700	24,750	3,291	2,874	3,291	3,111
24,750	24,800	3,299	2,881	3,299	3,119
24,800	24,850	3,306	2,889	3,306	3,126
24,850	24,900	3,314	2,896	3,314	3,134
24,900	24,950	3,321	2,904	3,321	3,141
24,950	25,000	3,329	2,911	3,329	3,149
25,000					
25,000	25,050	3,336	2,919	3,336	3,156
25,050	25,100	3,344	2,926	3,344	3,164
25,100	25,150	3,351	2,934	3,351	3,171
25,150	25,200	3,359	2,941	3,359	3,179
25,200	25,250	3,366	2,949	3,366	3,186
25,250	25,300	3,374	2,956	3,374	3,194
25,300	25,350	3,381	2,964	3,381	3,201
25,350	25,400	3,389	2,971	3,389	3,209
25,400	25,450	3,396	2,979	3,396	3,216
25,450	25,500	3,404	2,986	3,404	3,224
25,500	25,550	3,411	2,994	3,411	3,231
25,550	25,600	3,419	3,001	3,419	3,239
25,600	25,650	3,426	3,009	3,426	3,246
25,650	25,700	3,434	3,016	3,434	3,254
25,700	25,750	3,441	3,024	3,441	3,261
25,750	25,800	3,449	3,031	3,449	3,269
25,800	25,850	3,456	3,039	3,456	3,276
25,850	25,900	3,464	3,046	3,464	3,284
25,900	25,950	3,471	3,054	3,471	3,291
25,950	26,000	3,479	3,061	3,479	3,299
26,000					
26,000	26,050	3,486	3,069	3,486	3,306
26,050	26,100	3,494	3,076	3,494	3,314
26,100	26,150	3,501	3,084	3,501	3,321
26,150	26,200	3,509	3,091	3,509	3,329
26,200	26,250	3,516	3,099	3,516	3,336
26,250	26,300	3,524	3,106	3,524	3,344
26,300	26,350	3,531	3,114	3,531	3,351
26,350	26,400	3,539	3,121	3,539	3,359
26,400	26,450	3,546	3,129	3,546	3,366
26,450	26,500	3,554	3,136	3,554	3,374
26,500	26,550	3,561	3,144	3,561	3,381
26,550	26,600	3,569	3,151	3,569	3,389
26,600	26,650	3,576	3,159	3,576	3,396
26,650	26,700	3,584	3,166	3,584	3,404
26,700	26,750	3,591	3,174	3,591	3,411
26,750	26,800	3,599	3,181	3,599	3,419
26,800	26,850	3,606	3,189	3,606	3,426
26,850	26,900	3,614	3,196	3,614	3,434
26,900	26,950	3,621	3,204	3,621	3,441
26,950	27,000	3,629	3,211	3,629	3,449
27,000					
27,000	27,050	3,636	3,219	3,636	3,456
27,050	27,100	3,644	3,226	3,644	3,464
27,100	27,150	3,651	3,234	3,651	3,471
27,150	27,200	3,659	3,241	3,659	3,479
27,200	27,250	3,666	3,249	3,666	3,486
27,250	27,300	3,674	3,256	3,674	3,494
27,300	27,350	3,681	3,264	3,681	3,501
27,350	27,400	3,689	3,271	3,689	3,509
27,400	27,450	3,696	3,279	3,696	3,516
27,450	27,500	3,704	3,286	3,704	3,524
27,500	27,550	3,711	3,294	3,711	3,531
27,550	27,600	3,719	3,301	3,719	3,539
27,600	27,650	3,726	3,309	3,726	3,546
27,650	27,700	3,734	3,316	3,734	3,554
27,700	27,750	3,741	3,324	3,741	3,561
27,750	27,800	3,749	3,331	3,749	3,569
27,800	27,850	3,756	3,339	3,756	3,576
27,850	27,900	3,764	3,346	3,764	3,584
27,900	27,950	3,771	3,354	3,771	3,591
27,950	28,000	3,779	3,361	3,779	3,599
28,000					
28,000	28,050	3,786	3,369	3,786	3,606
28,050	28,100	3,794	3,376	3,794	3,614
28,100	28,150	3,801	3,384	3,801	3,621
28,150	28,200	3,809	3,391	3,809	3,629
28,200	28,250	3,816	3,399	3,816	3,636
28,250	28,300	3,824	3,406	3,824	3,644
28,300	28,350	3,831	3,414	3,831	3,651
28,350	28,400	3,839	3,421	3,839	3,659
28,400	28,450	3,846	3,429	3,846	3,666
28,450	28,500	3,854	3,436	3,854	3,674
28,500	28,550	3,861	3,444	3,861	3,681
28,550	28,600	3,869	3,451	3,869	3,689
28,600	28,650	3,876	3,459	3,876	3,696
28,650	28,700	3,884	3,466	3,884	3,704
28,700	28,750	3,891	3,474	3,891	3,711
28,750	28,800	3,899	3,481	3,899	3,719
28,800	28,850	3,906	3,489	3,906	3,726
28,850	28,900	3,914	3,496	3,914	3,734
28,900	28,950	3,921	3,504	3,921	3,741
28,950	29,000	3,929	3,511	3,929	3,749
29,000					
29,000	29,050	3,936	3,519	3,936	3,756
29,050	29,100	3,944	3,526	3,944	3,764
29,100	29,150	3,951	3,534	3,951	3,771
29,150	29,200	3,959	3,541	3,959	3,779
29,200	29,250	3,966	3,549	3,966	3,786
29,250	29,300	3,974	3,556	3,974	3,794
29,300	29,350	3,981	3,564	3,981	3,801
29,350	29,400	3,989	3,571	3,989	3,809
29,400	29,450	3,996	3,579	3,996	3,816
29,450	29,500	4,004	3,586	4,004	3,824
29,500	29,550	4,011	3,594	4,011	3,831
29,550	29,600	4,019	3,601	4,019	3,839
29,600	29,650	4,026	3,609	4,026	3,846
29,650	29,700	4,034	3,616	4,034	3,854
29,700	29,750	4,041	3,624	4,041	3,861
29,750	29,800	4,049	3,631	4,049	3,869
29,800	29,850	4,056	3,639	4,056	3,876
29,850	29,900	4,064	3,646	4,064	3,884
29,900	29,950	4,071	3,654	4,071	3,891
29,950	30,000	4,079	3,661	4,079	3,899
30,000					
30,000	30,050	4,086	3,669	4,086	3,906
30,050	30,100	4,094	3,676	4,094	3,914
30,100	30,150	4,101	3,684	4,101	3,921
30,150	30,200	4,109	3,691	4,109	3,929
30,200	30,250	4,116	3,699	4,116	3,936
30,250	30,300	4,124	3,706	4,124	3,944
30,300	30,350	4,131	3,714	4,131	3,951
30,350	30,400	4,139	3,721	4,139	3,959
30,400	30,450	4,146	3,729	4,146	3,966
30,450	30,500	4,154	3,736	4,154	3,974
30,500	30,550	4,161	3,744	4,161	3,981
30,550	30,600	4,169	3,751	4,169	3,989
30,600	30,650	4,176	3,759	4,176	3,996
30,650	30,700	4,184	3,766	4,184	4,004
30,700	30,750	4,191	3,774	4,191	4,011
30,750	30,800	4,199	3,781	4,199	4,019
30,800	30,850	4,206	3,789	4,206	4,026
30,850	30,900	4,214	3,796	4,214	4,034
30,900	30,950	4,221	3,804	4,221	4,041
30,950	31,000	4,229	3,811	4,229	4,049
31,000					
31,000	31,050	4,236	3,819	4,236	4,056
31,050	31,100	4,244	3,826	4,244	4,064
31,100	31,150	4,251	3,834	4,251	4,071
31,150	31,200	4,259	3,841	4,259	4,079
31,200	31,250	4,266	3,849	4,266	4,086
31,250	31,300	4,274	3,856	4,274	4,094
31,300	31,350	4,281	3,864	4,281	4,101
31,350	31,400	4,289	3,871	4,289	4,109
31,400	31,450	4,296	3,879	4,296	4,116
31,450	31,500	4,304	3,886	4,304	4,124
31,500	31,550	4,311	3,894	4,311	4,131
31,550	31,600	4,319	3,901	4,319	4,139
31,600	31,650	4,326	3,909	4,326	4,146
31,650	31,700	4,334	3,916	4,334	4,154
31,700	31,750	4,341	3,924	4,341	4,161
31,750	31,800	4,349	3,931	4,349	4,169
31,800	31,850	4,356	3,939	4,356	4,176
31,850	31,900	4,364	3,946	4,364	4,184
31,900	31,950	4,371	3,954	4,371	4,191
31,950	32,000	4,379	3,961	4,379	4,199

*This column must also be used by a qualifying widow(er).

(Continued on next page)

2009 Tax Table–*Continued*

If line 43 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—			
32,000					
32,000	32,050	4,386	3,969	4,386	4,206
32,050	32,100	4,394	3,976	4,394	4,214
32,100	32,150	4,401	3,984	4,401	4,221
32,150	32,200	4,409	3,991	4,409	4,229
32,200	32,250	4,416	3,999	4,416	4,236
32,250	32,300	4,424	4,006	4,424	4,244
32,300	32,350	4,431	4,014	4,431	4,251
32,350	32,400	4,439	4,021	4,439	4,259
32,400	32,450	4,446	4,029	4,446	4,266
32,450	32,500	4,454	4,036	4,454	4,274
32,500	32,550	4,461	4,044	4,461	4,281
32,550	32,600	4,469	4,051	4,469	4,289
32,600	32,650	4,476	4,059	4,476	4,296
32,650	32,700	4,484	4,066	4,484	4,304
32,700	32,750	4,491	4,074	4,491	4,311
32,750	32,800	4,499	4,081	4,499	4,319
32,800	32,850	4,506	4,089	4,506	4,326
32,850	32,900	4,514	4,096	4,514	4,334
32,900	32,950	4,521	4,104	4,521	4,341
32,950	33,000	4,529	4,111	4,529	4,349
33,000					
33,000	33,050	4,536	4,119	4,536	4,356
33,050	33,100	4,544	4,126	4,544	4,364
33,100	33,150	4,551	4,134	4,551	4,371
33,150	33,200	4,559	4,141	4,559	4,379
33,200	33,250	4,566	4,149	4,566	4,386
33,250	33,300	4,574	4,156	4,574	4,394
33,300	33,350	4,581	4,164	4,581	4,401
33,350	33,400	4,589	4,171	4,589	4,409
33,400	33,450	4,596	4,179	4,596	4,416
33,450	33,500	4,604	4,186	4,604	4,424
33,500	33,550	4,611	4,194	4,611	4,431
33,550	33,600	4,619	4,201	4,619	4,439
33,600	33,650	4,626	4,209	4,626	4,446
33,650	33,700	4,634	4,216	4,634	4,454
33,700	33,750	4,641	4,224	4,641	4,461
33,750	33,800	4,649	4,231	4,649	4,469
33,800	33,850	4,656	4,239	4,656	4,476
33,850	33,900	4,664	4,246	4,664	4,484
33,900	33,950	4,671	4,254	4,671	4,491
33,950	34,000	4,681	4,261	4,681	4,499
34,000					
34,000	34,050	4,694	4,269	4,694	4,506
34,050	34,100	4,706	4,276	4,706	4,514
34,100	34,150	4,719	4,284	4,719	4,521
34,150	34,200	4,731	4,291	4,731	4,529
34,200	34,250	4,744	4,299	4,744	4,536
34,250	34,300	4,756	4,306	4,756	4,544
34,300	34,350	4,769	4,314	4,769	4,551
34,350	34,400	4,781	4,321	4,781	4,559
34,400	34,450	4,794	4,329	4,794	4,566
34,450	34,500	4,806	4,336	4,806	4,574
34,500	34,550	4,819	4,344	4,819	4,581
34,550	34,600	4,831	4,351	4,831	4,589
34,600	34,650	4,844	4,359	4,844	4,596
34,650	34,700	4,856	4,366	4,856	4,604
34,700	34,750	4,869	4,374	4,869	4,611
34,750	34,800	4,881	4,381	4,881	4,619
34,800	34,850	4,894	4,389	4,894	4,626
34,850	34,900	4,906	4,396	4,906	4,634
34,900	34,950	4,919	4,404	4,919	4,641
34,950	35,000	4,931	4,411	4,931	4,649

If line 43 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—			
35,000					
35,000	35,050	4,944	4,419	4,944	4,656
35,050	35,100	4,956	4,426	4,956	4,664
35,100	35,150	4,969	4,434	4,969	4,671
35,150	35,200	4,981	4,441	4,981	4,679
35,200	35,250	4,994	4,449	4,994	4,686
35,250	35,300	5,006	4,456	5,006	4,694
35,300	35,350	5,019	4,464	5,019	4,701
35,350	35,400	5,031	4,471	5,031	4,709
35,400	35,450	5,044	4,479	5,044	4,716
35,450	35,500	5,056	4,486	5,056	4,724
35,500	35,550	5,069	4,494	5,069	4,731
35,550	35,600	5,081	4,501	5,081	4,739
35,600	35,650	5,094	4,509	5,094	4,746
35,650	35,700	5,106	4,516	5,106	4,754
35,700	35,750	5,119	4,524	5,119	4,761
35,750	35,800	5,131	4,531	5,131	4,769
35,800	35,850	5,144	4,539	5,144	4,776
35,850	35,900	5,156	4,546	5,156	4,784
35,900	35,950	5,169	4,554	5,169	4,791
35,950	36,000	5,181	4,561	5,181	4,799
36,000					
36,000	36,050	5,194	4,569	5,194	4,806
36,050	36,100	5,206	4,576	5,206	4,814
36,100	36,150	5,219	4,584	5,219	4,821
36,150	36,200	5,231	4,591	5,231	4,829
36,200	36,250	5,244	4,599	5,244	4,836
36,250	36,300	5,256	4,606	5,256	4,844
36,300	36,350	5,269	4,614	5,269	4,851
36,350	36,400	5,281	4,621	5,281	4,859
36,400	36,450	5,294	4,629	5,294	4,866
36,450	36,500	5,306	4,636	5,306	4,874
36,500	36,550	5,319	4,644	5,319	4,881
36,550	36,600	5,331	4,651	5,331	4,889
36,600	36,650	5,344	4,659	5,344	4,896
36,650	36,700	5,356	4,666	5,356	4,904
36,700	36,750	5,369	4,674	5,369	4,911
36,750	36,800	5,381	4,681	5,381	4,919
36,800	36,850	5,394	4,689	5,394	4,926
36,850	36,900	5,406	4,696	5,406	4,934
36,900	36,950	5,419	4,704	5,419	4,941
36,950	37,000	5,431	4,711	5,431	4,949
37,000					
37,000	37,050	5,444	4,719	5,444	4,956
37,050	37,100	5,456	4,726	5,456	4,964
37,100	37,150	5,469	4,734	5,469	4,971
37,150	37,200	5,481	4,741	5,481	4,979
37,200	37,250	5,494	4,749	5,494	4,986
37,250	37,300	5,506	4,756	5,506	4,994
37,300	37,350	5,519	4,764	5,519	5,001
37,350	37,400	5,531	4,771	5,531	5,009
37,400	37,450	5,544	4,779	5,544	5,016
37,450	37,500	5,556	4,786	5,556	5,024
37,500	37,550	5,569	4,794	5,569	5,031
37,550	37,600	5,581	4,801	5,581	5,039
37,600	37,650	5,594	4,809	5,594	5,046
37,650	37,700	5,606	4,816	5,606	5,054
37,700	37,750	5,619	4,824	5,619	5,061
37,750	37,800	5,631	4,831	5,631	5,069
37,800	37,850	5,644	4,839	5,644	5,076
37,850	37,900	5,656	4,846	5,656	5,084
37,900	37,950	5,669	4,854	5,669	5,091
37,950	38,000	5,681	4,861	5,681	5,099

If line 43 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—			
38,000					
38,000	38,050	5,694	4,869	5,694	5,106
38,050	38,100	5,706	4,876	5,706	5,114
38,100	38,150	5,719	4,884	5,719	5,121
38,150	38,200	5,731	4,891	5,731	5,129
38,200	38,250	5,744	4,899	5,744	5,136
38,250	38,300	5,756	4,906	5,756	5,144
38,300	38,350	5,769	4,914	5,769	5,151
38,350	38,400	5,781	4,921	5,781	5,159
38,400	38,450	5,794	4,929	5,794	5,166
38,450	38,500	5,806	4,936	5,806	5,174
38,500	38,550	5,819	4,944	5,819	5,181
38,550	38,600	5,831	4,951	5,831	5,189
38,600	38,650	5,844	4,959	5,844	5,196
38,650	38,700	5,856	4,966	5,856	5,204
38,700	38,750	5,869	4,974	5,869	5,211
38,750	38,800	5,881	4,981	5,881	5,219
38,800	38,850	5,894	4,989	5,894	5,226
38,850	38,900	5,906	4,996	5,906	5,234
38,900	38,950	5,919	5,004	5,919	5,241
38,950	39,000	5,931	5,011	5,931	5,249
39,000					
39,000	39,050	5,944	5,019	5,944	5,256
39,050	39,100	5,956	5,026	5,956	5,264
39,100	39,150	5,969	5,034	5,969	5,271
39,150	39,200	5,981	5,041	5,981	5,279
39,200	39,250	5,994	5,049	5,994	5,286
39,250	39,300	6,006	5,056	6,006	5,294
39,300	39,350	6,019	5,064	6,019	5,301
39,350	39,400	6,031	5,071	6,031	5,309
39,400	39,450	6,044	5,079	6,044	5,316
39,450	39,500	6,056	5,086	6,056	5,324
39,500	39,550	6,069	5,094	6,069	5,331
39,550	39,600	6,081	5,101	6,081	5,339
39,600	39,650	6,094	5,109	6,094	5,346
39,650	39,700	6,106	5,116	6,106	5,354
39,700	39,750	6,119	5,124	6,119	5,361
39,750	39,800	6,131	5,131	6,131	5,369
39,800	39,850	6,144	5,139	6,144	5,376
39,850	39,900	6,156	5,146	6,156	5,384
39,900	39,950	6,169	5,154	6,169	5,391
39,950	40,000	6,181	5,161	6,181	5,399
40,000					
40,000	40,050	6,194	5,169	6,194	5,406
40,050	40,100	6,206	5,176	6,206	5,414
40,100	40,150	6,219	5,184	6,219	5,421
40,150	40,200	6,231	5,191	6,231	5,429
40,200	40,250	6,244	5,199	6,244	5,436
40,250	40,300	6,256	5,206	6,256	5,444
40,300	40,350	6,269	5,214	6,269	5,451
40,350	40,400	6,281	5,221	6,281	5,459
40,400	40,450	6,294	5,229	6,294	5,466
40,450	40,500	6,306	5,236	6,306	5,474
40,500	40,550	6,319	5,244	6,319	5,481
40,550	40,600	6,331	5,251	6,331	5,489
40,600	40,650	6,344	5,259	6,344	5,496
40,650	40,700	6,356	5,266	6,356	5,504
40,700	40,750	6,369	5,274	6,369	5,511
40,750	40,800	6,381	5,281	6,381	5,519
40,800	40,850	6,394	5,289	6,394	5,526
40,850	40,900	6,406	5,296	6,406	5,534
40,900	40,950	6,419	5,304	6,419	5,541
40,950	41,000	6,431	5,311	6,431	5,549

*This column must also be used by a qualifying widow(er).

(Continued on next page)

2009 Tax Table–*Continued*

If line 43 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—			
41,000					
41,000	41,050	6,444	5,319	6,444	5,556
41,050	41,100	6,456	5,326	6,456	5,564
41,100	41,150	6,469	5,334	6,469	5,571
41,150	41,200	6,481	5,341	6,481	5,579
41,200	41,250	6,494	5,349	6,494	5,586
41,250	41,300	6,506	5,356	6,506	5,594
41,300	41,350	6,519	5,364	6,519	5,601
41,350	41,400	6,531	5,371	6,531	5,609
41,400	41,450	6,544	5,379	6,544	5,616
41,450	41,500	6,556	5,386	6,556	5,624
41,500	41,550	6,569	5,394	6,569	5,631
41,550	41,600	6,581	5,401	6,581	5,639
41,600	41,650	6,594	5,409	6,594	5,646
41,650	41,700	6,606	5,416	6,606	5,654
41,700	41,750	6,619	5,424	6,619	5,661
41,750	41,800	6,631	5,431	6,631	5,669
41,800	41,850	6,644	5,439	6,644	5,676
41,850	41,900	6,656	5,446	6,656	5,684
41,900	41,950	6,669	5,454	6,669	5,691
41,950	42,000	6,681	5,461	6,681	5,699
42,000					
42,000	42,050	6,694	5,469	6,694	5,706
42,050	42,100	6,706	5,476	6,706	5,714
42,100	42,150	6,719	5,484	6,719	5,721
42,150	42,200	6,731	5,491	6,731	5,729
42,200	42,250	6,744	5,499	6,744	5,736
42,250	42,300	6,756	5,506	6,756	5,744
42,300	42,350	6,769	5,514	6,769	5,751
42,350	42,400	6,781	5,521	6,781	5,759
42,400	42,450	6,794	5,529	6,794	5,766
42,450	42,500	6,806	5,536	6,806	5,774
42,500	42,550	6,819	5,544	6,819	5,781
42,550	42,600	6,831	5,551	6,831	5,789
42,600	42,650	6,844	5,559	6,844	5,796
42,650	42,700	6,856	5,566	6,856	5,804
42,700	42,750	6,869	5,574	6,869	5,811
42,750	42,800	6,881	5,581	6,881	5,819
42,800	42,850	6,894	5,589	6,894	5,826
42,850	42,900	6,906	5,596	6,906	5,834
42,900	42,950	6,919	5,604	6,919	5,841
42,950	43,000	6,931	5,611	6,931	5,849
43,000					
43,000	43,050	6,944	5,619	6,944	5,856
43,050	43,100	6,956	5,626	6,956	5,864
43,100	43,150	6,969	5,634	6,969	5,871
43,150	43,200	6,981	5,641	6,981	5,879
43,200	43,250	6,994	5,649	6,994	5,886
43,250	43,300	7,006	5,656	7,006	5,894
43,300	43,350	7,019	5,664	7,019	5,901
43,350	43,400	7,031	5,671	7,031	5,909
43,400	43,450	7,044	5,679	7,044	5,916
43,450	43,500	7,056	5,686	7,056	5,924
43,500	43,550	7,069	5,694	7,069	5,931
43,550	43,600	7,081	5,701	7,081	5,939
43,600	43,650	7,094	5,709	7,094	5,946
43,650	43,700	7,106	5,716	7,106	5,954
43,700	43,750	7,119	5,724	7,119	5,961
43,750	43,800	7,131	5,731	7,131	5,969
43,800	43,850	7,144	5,739	7,144	5,976
43,850	43,900	7,156	5,746	7,156	5,984
43,900	43,950	7,169	5,754	7,169	5,991
43,950	44,000	7,181	5,761	7,181	5,999
44,000					
44,000	44,050	7,194	5,769	7,194	6,006
44,050	44,100	7,206	5,776	7,206	6,014
44,100	44,150	7,219	5,784	7,219	6,021
44,150	44,200	7,231	5,791	7,231	6,029
44,200	44,250	7,244	5,799	7,244	6,036
44,250	44,300	7,256	5,806	7,256	6,044
44,300	44,350	7,269	5,814	7,269	6,051
44,350	44,400	7,281	5,821	7,281	6,059
44,400	44,450	7,294	5,829	7,294	6,066
44,450	44,500	7,306	5,836	7,306	6,074
44,500	44,550	7,319	5,844	7,319	6,081
44,550	44,600	7,331	5,851	7,331	6,089
44,600	44,650	7,344	5,859	7,344	6,096
44,650	44,700	7,356	5,866	7,356	6,104
44,700	44,750	7,369	5,874	7,369	6,111
44,750	44,800	7,381	5,881	7,381	6,119
44,800	44,850	7,394	5,889	7,394	6,126
44,850	44,900	7,406	5,896	7,406	6,134
44,900	44,950	7,419	5,904	7,419	6,141
44,950	45,000	7,431	5,911	7,431	6,149
45,000					
45,000	45,050	7,444	5,919	7,444	6,156
45,050	45,100	7,456	5,926	7,456	6,164
45,100	45,150	7,469	5,934	7,469	6,171
45,150	45,200	7,481	5,941	7,481	6,179
45,200	45,250	7,494	5,949	7,494	6,186
45,250	45,300	7,506	5,956	7,506	6,194
45,300	45,350	7,519	5,964	7,519	6,201
45,350	45,400	7,531	5,971	7,531	6,209
45,400	45,450	7,544	5,979	7,544	6,216
45,450	45,500	7,556	5,986	7,556	6,224
45,500	45,550	7,569	5,994	7,569	6,234
45,550	45,600	7,581	6,001	7,581	6,246
45,600	45,650	7,594	6,009	7,594	6,259
45,650	45,700	7,606	6,016	7,606	6,271
45,700	45,750	7,619	6,024	7,619	6,284
45,750	45,800	7,631	6,031	7,631	6,296
45,800	45,850	7,644	6,039	7,644	6,309
45,850	45,900	7,656	6,046	7,656	6,321
45,900	45,950	7,669	6,054	7,669	6,334
45,950	46,000	7,681	6,061	7,681	6,346
46,000					
46,000	46,050	7,694	6,069	7,694	6,359
46,050	46,100	7,706	6,076	7,706	6,371
46,100	46,150	7,719	6,084	7,719	6,384
46,150	46,200	7,731	6,091	7,731	6,396
46,200	46,250	7,744	6,099	7,744	6,409
46,250	46,300	7,756	6,106	7,756	6,421
46,300	46,350	7,769	6,114	7,769	6,434
46,350	46,400	7,781	6,121	7,781	6,446
46,400	46,450	7,794	6,129	7,794	6,459
46,450	46,500	7,806	6,136	7,806	6,471
46,500	46,550	7,819	6,144	7,819	6,484
46,550	46,600	7,831	6,151	7,831	6,496
46,600	46,650	7,844	6,159	7,844	6,509
46,650	46,700	7,856	6,166	7,856	6,521
46,700	46,750	7,869	6,174	7,869	6,534
46,750	46,800	7,881	6,181	7,881	6,546
46,800	46,850	7,894	6,189	7,894	6,559
46,850	46,900	7,906	6,196	7,906	6,571
46,900	46,950	7,919	6,204	7,919	6,584
46,950	47,000	7,931	6,211	7,931	6,596
47,000					
47,000	47,050	7,944	6,219	7,944	6,609
47,050	47,100	7,956	6,226	7,956	6,621
47,100	47,150	7,969	6,234	7,969	6,634
47,150	47,200	7,981	6,241	7,981	6,646
47,200	47,250	7,994	6,249	7,994	6,659
47,250	47,300	8,006	6,256	8,006	6,671
47,300	47,350	8,019	6,264	8,019	6,684
47,350	47,400	8,031	6,271	8,031	6,696
47,400	47,450	8,044	6,279	8,044	6,709
47,450	47,500	8,056	6,286	8,056	6,721
47,500	47,550	8,069	6,294	8,069	6,734
47,550	47,600	8,081	6,301	8,081	6,746
47,600	47,650	8,094	6,309	8,094	6,759
47,650	47,700	8,106	6,316	8,106	6,771
47,700	47,750	8,119	6,324	8,119	6,784
47,750	47,800	8,131	6,331	8,131	6,796
47,800	47,850	8,144	6,339	8,144	6,809
47,850	47,900	8,156	6,346	8,156	6,821
47,900	47,950	8,169	6,354	8,169	6,834
47,950	48,000	8,181	6,361	8,181	6,846
48,000					
48,000	48,050	8,194	6,369	8,194	6,859
48,050	48,100	8,206	6,376	8,206	6,871
48,100	48,150	8,219	6,384	8,219	6,884
48,150	48,200	8,231	6,391	8,231	6,896
48,200	48,250	8,244	6,399	8,244	6,909
48,250	48,300	8,256	6,406	8,256	6,921
48,300	48,350	8,269	6,414	8,269	6,934
48,350	48,400	8,281	6,421	8,281	6,946
48,400	48,450	8,294	6,429	8,294	6,959
48,450	48,500	8,306	6,436	8,306	6,971
48,500	48,550	8,319	6,444	8,319	6,984
48,550	48,600	8,331	6,451	8,331	6,996
48,600	48,650	8,344	6,459	8,344	7,009
48,650	48,700	8,356	6,466	8,356	7,021
48,700	48,750	8,369	6,474	8,369	7,034
48,750	48,800	8,381	6,481	8,381	7,046
48,800	48,850	8,394	6,489	8,394	7,059
48,850	48,900	8,406	6,496	8,406	7,071
48,900	48,950	8,419	6,504	8,419	7,084
48,950	49,000	8,431	6,511	8,431	7,096
49,000					
49,000	49,050	8,444	6,519	8,444	7,109
49,050	49,100	8,456	6,526	8,456	7,121
49,100	49,150	8,469	6,534	8,469	7,134
49,150	49,200	8,481	6,541	8,481	7,146
49,200	49,250	8,494	6,549	8,494	7,159
49,250	49,300	8,506	6,556	8,506	7,171
49,300	49,350	8,519	6,564	8,519	7,184
49,350	49,400	8,531	6,571	8,531	7,196
49,400	49,450	8,544	6,579	8,544	7,209
49,450	49,500	8,556	6,586	8,556	7,221
49,500	49,550	8,569	6,594	8,569	7,234
49,550	49,600	8,581	6,601	8,581	7,246
49,600	49,650	8,594	6,609	8,594	7,259
49,650	49,700	8,606	6,616	8,606	7,271
49,700	49,750	8,619	6,624	8,619	7,284
49,750	49,800	8,631	6,631	8,631	7,296
49,800	49,850	8,644	6,639	8,644	7,309
49,850	49,900	8,656	6,646	8,656	7,321
49,900	49,950	8,669	6,654	8,669	7,334
49,950	50,000	8,681	6,661	8,681	7,346

*This column must also be used by a qualifying widow(er).

(Continued on next page)

2009 Tax Table–*Continued*

If line 43 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—			
50,000					
50,000	50,050	8,694	6,669	8,694	7,359
50,050	50,100	8,706	6,676	8,706	7,371
50,100	50,150	8,719	6,684	8,719	7,384
50,150	50,200	8,731	6,691	8,731	7,396
50,200	50,250	8,744	6,699	8,744	7,409
50,250	50,300	8,756	6,706	8,756	7,421
50,300	50,350	8,769	6,714	8,769	7,434
50,350	50,400	8,781	6,721	8,781	7,446
50,400	50,450	8,794	6,729	8,794	7,459
50,450	50,500	8,806	6,736	8,806	7,471
50,500	50,550	8,819	6,744	8,819	7,484
50,550	50,600	8,831	6,751	8,831	7,496
50,600	50,650	8,844	6,759	8,844	7,509
50,650	50,700	8,856	6,766	8,856	7,521
50,700	50,750	8,869	6,774	8,869	7,534
50,750	50,800	8,881	6,781	8,881	7,546
50,800	50,850	8,894	6,789	8,894	7,559
50,850	50,900	8,906	6,796	8,906	7,571
50,900	50,950	8,919	6,804	8,919	7,584
50,950	51,000	8,931	6,811	8,931	7,596
51,000					
51,000	51,050	8,944	6,819	8,944	7,609
51,050	51,100	8,956	6,826	8,956	7,621
51,100	51,150	8,969	6,834	8,969	7,634
51,150	51,200	8,981	6,841	8,981	7,646
51,200	51,250	8,994	6,849	8,994	7,659
51,250	51,300	9,006	6,856	9,006	7,671
51,300	51,350	9,019	6,864	9,019	7,684
51,350	51,400	9,031	6,871	9,031	7,696
51,400	51,450	9,044	6,879	9,044	7,709
51,450	51,500	9,056	6,886	9,056	7,721
51,500	51,550	9,069	6,894	9,069	7,734
51,550	51,600	9,081	6,901	9,081	7,746
51,600	51,650	9,094	6,909	9,094	7,759
51,650	51,700	9,106	6,916	9,106	7,771
51,700	51,750	9,119	6,924	9,119	7,784
51,750	51,800	9,131	6,931	9,131	7,796
51,800	51,850	9,144	6,939	9,144	7,809
51,850	51,900	9,156	6,946	9,156	7,821
51,900	51,950	9,169	6,954	9,169	7,834
51,950	52,000	9,181	6,961	9,181	7,846
52,000					
52,000	52,050	9,194	6,969	9,194	7,859
52,050	52,100	9,206	6,976	9,206	7,871
52,100	52,150	9,219	6,984	9,219	7,884
52,150	52,200	9,231	6,991	9,231	7,896
52,200	52,250	9,244	6,999	9,244	7,909
52,250	52,300	9,256	7,006	9,256	7,921
52,300	52,350	9,269	7,014	9,269	7,934
52,350	52,400	9,281	7,021	9,281	7,946
52,400	52,450	9,294	7,029	9,294	7,959
52,450	52,500	9,306	7,036	9,306	7,971
52,500	52,550	9,319	7,044	9,319	7,984
52,550	52,600	9,331	7,051	9,331	7,996
52,600	52,650	9,344	7,059	9,344	8,009
52,650	52,700	9,356	7,066	9,356	8,021
52,700	52,750	9,369	7,074	9,369	8,034
52,750	52,800	9,381	7,081	9,381	8,046
52,800	52,850	9,394	7,089	9,394	8,059
52,850	52,900	9,406	7,096	9,406	8,071
52,900	52,950	9,419	7,104	9,419	8,084
52,950	53,000	9,431	7,111	9,431	8,096
53,000					
53,000	53,050	9,444	7,119	9,444	8,109
53,050	53,100	9,456	7,126	9,456	8,121
53,100	53,150	9,469	7,134	9,469	8,134
53,150	53,200	9,481	7,141	9,481	8,146
53,200	53,250	9,494	7,149	9,494	8,159
53,250	53,300	9,506	7,156	9,506	8,171
53,300	53,350	9,519	7,164	9,519	8,184
53,350	53,400	9,531	7,171	9,531	8,196
53,400	53,450	9,544	7,179	9,544	8,209
53,450	53,500	9,556	7,186	9,556	8,221
53,500	53,550	9,569	7,194	9,569	8,234
53,550	53,600	9,581	7,201	9,581	8,246
53,600	53,650	9,594	7,209	9,594	8,259
53,650	53,700	9,606	7,216	9,606	8,271
53,700	53,750	9,619	7,224	9,619	8,284
53,750	53,800	9,631	7,231	9,631	8,296
53,800	53,850	9,644	7,239	9,644	8,309
53,850	53,900	9,656	7,246	9,656	8,321
53,900	53,950	9,669	7,254	9,669	8,334
53,950	54,000	9,681	7,261	9,681	8,346
54,000					
54,000	54,050	9,694	7,269	9,694	8,359
54,050	54,100	9,706	7,276	9,706	8,371
54,100	54,150	9,719	7,284	9,719	8,384
54,150	54,200	9,731	7,291	9,731	8,396
54,200	54,250	9,744	7,299	9,744	8,409
54,250	54,300	9,756	7,306	9,756	8,421
54,300	54,350	9,769	7,314	9,769	8,434
54,350	54,400	9,781	7,321	9,781	8,446
54,400	54,450	9,794	7,329	9,794	8,459
54,450	54,500	9,806	7,336	9,806	8,471
54,500	54,550	9,819	7,344	9,819	8,484
54,550	54,600	9,831	7,351	9,831	8,496
54,600	54,650	9,844	7,359	9,844	8,509
54,650	54,700	9,856	7,366	9,856	8,521
54,700	54,750	9,869	7,374	9,869	8,534
54,750	54,800	9,881	7,381	9,881	8,546
54,800	54,850	9,894	7,389	9,894	8,559
54,850	54,900	9,906	7,396	9,906	8,571
54,900	54,950	9,919	7,404	9,919	8,584
54,950	55,000	9,931	7,411	9,931	8,596
55,000					
55,000	55,050	9,944	7,419	9,944	8,609
55,050	55,100	9,956	7,426	9,956	8,621
55,100	55,150	9,969	7,434	9,969	8,634
55,150	55,200	9,981	7,441	9,981	8,646
55,200	55,250	9,994	7,449	9,994	8,659
55,250	55,300	10,006	7,456	10,006	8,671
55,300	55,350	10,019	7,464	10,019	8,684
55,350	55,400	10,031	7,471	10,031	8,696
55,400	55,450	10,044	7,479	10,044	8,709
55,450	55,500	10,056	7,486	10,056	8,721
55,500	55,550	10,069	7,494	10,069	8,734
55,550	55,600	10,081	7,501	10,081	8,746
55,600	55,650	10,094	7,509	10,094	8,759
55,650	55,700	10,106	7,516	10,106	8,771
55,700	55,750	10,119	7,524	10,119	8,784
55,750	55,800	10,131	7,531	10,131	8,796
55,800	55,850	10,144	7,539	10,144	8,809
55,850	55,900	10,156	7,546	10,156	8,821
55,900	55,950	10,169	7,554	10,169	8,834
55,950	56,000	10,181	7,561	10,181	8,846
56,000					
56,000	56,050	10,194	7,569	10,194	8,859
56,050	56,100	10,206	7,576	10,206	8,871
56,100	56,150	10,219	7,584	10,219	8,884
56,150	56,200	10,231	7,591	10,231	8,896
56,200	56,250	10,244	7,599	10,244	8,909
56,250	56,300	10,256	7,606	10,256	8,921
56,300	56,350	10,269	7,614	10,269	8,934
56,350	56,400	10,281	7,621	10,281	8,946
56,400	56,450	10,294	7,629	10,294	8,959
56,450	56,500	10,306	7,636	10,306	8,971
56,500	56,550	10,319	7,644	10,319	8,984
56,550	56,600	10,331	7,651	10,331	8,996
56,600	56,650	10,344	7,659	10,344	9,009
56,650	56,700	10,356	7,666	10,356	9,021
56,700	56,750	10,369	7,674	10,369	9,034
56,750	56,800	10,381	7,681	10,381	9,046
56,800	56,850	10,394	7,689	10,394	9,059
56,850	56,900	10,406	7,696	10,406	9,071
56,900	56,950	10,419	7,704	10,419	9,084
56,950	57,000	10,431	7,711	10,431	9,096
57,000					
57,000	57,050	10,444	7,719	10,444	9,109
57,050	57,100	10,456	7,726	10,456	9,121
57,100	57,150	10,469	7,734	10,469	9,134
57,150	57,200	10,481	7,741	10,481	9,146
57,200	57,250	10,494	7,749	10,494	9,159
57,250	57,300	10,506	7,756	10,506	9,171
57,300	57,350	10,519	7,764	10,519	9,184
57,350	57,400	10,531	7,771	10,531	9,196
57,400	57,450	10,544	7,779	10,544	9,209
57,450	57,500	10,556	7,786	10,556	9,221
57,500	57,550	10,569	7,794	10,569	9,234
57,550	57,600	10,581	7,801	10,581	9,246
57,600	57,650	10,594	7,809	10,594	9,259
57,650	57,700	10,606	7,816	10,606	9,271
57,700	57,750	10,619	7,824	10,619	9,284
57,750	57,800	10,631	7,831	10,631	9,296
57,800	57,850	10,644	7,839	10,644	9,309
57,850	57,900	10,656	7,846	10,656	9,321
57,900	57,950	10,669	7,854	10,669	9,334
57,950	58,000	10,681	7,861	10,681	9,346
58,000					
58,000	58,050	10,694	7,869	10,694	9,359
58,050	58,100	10,706	7,876	10,706	9,371
58,100	58,150	10,719	7,884	10,719	9,384
58,150	58,200	10,731	7,891	10,731	9,396
58,200	58,250	10,744	7,899	10,744	9,409
58,250	58,300	10,756	7,906	10,756	9,421
58,300	58,350	10,769	7,914	10,769	9,434
58,350	58,400	10,781	7,921	10,781	9,446
58,400	58,450	10,794	7,929	10,794	9,459
58,450	58,500	10,806	7,936	10,806	9,471
58,500	58,550	10,819	7,944	10,819	9,484
58,550	58,600	10,831	7,951	10,831	9,496
58,600	58,650	10,844	7,959	10,844	9,509
58,650	58,700	10,856	7,966	10,856	9,521
58,700	58,750	10,869	7,974	10,869	9,534
58,750	58,800	10,881	7,981	10,881	9,546
58,800	58,850	10,894	7,989	10,894	9,559
58,850	58,900	10,906	7,996	10,906	9,571
58,900	58,950	10,919	8,004	10,919	9,584
58,950	59,000	10,931	8,011	10,931	9,596

*This column must also be used by a qualifying widow(er).

(Continued on next page)

2009 Tax Table–*Continued*

If line 43 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—			
59,000					
59,000	59,050	10,944	8,019	10,944	9,609
59,050	59,100	10,956	8,026	10,956	9,621
59,100	59,150	10,969	8,034	10,969	9,634
59,150	59,200	10,981	8,041	10,981	9,646
59,200	59,250	10,994	8,049	10,994	9,659
59,250	59,300	11,006	8,056	11,006	9,671
59,300	59,350	11,019	8,064	11,019	9,684
59,350	59,400	11,031	8,071	11,031	9,696
59,400	59,450	11,044	8,079	11,044	9,709
59,450	59,500	11,056	8,086	11,056	9,721
59,500	59,550	11,069	8,094	11,069	9,734
59,550	59,600	11,081	8,101	11,081	9,746
59,600	59,650	11,094	8,109	11,094	9,759
59,650	59,700	11,106	8,116	11,106	9,771
59,700	59,750	11,119	8,124	11,119	9,784
59,750	59,800	11,131	8,131	11,131	9,796
59,800	59,850	11,144	8,139	11,144	9,809
59,850	59,900	11,156	8,146	11,156	9,821
59,900	59,950	11,169	8,154	11,169	9,834
59,950	60,000	11,181	8,161	11,181	9,846
60,000					
60,000	60,050	11,194	8,169	11,194	9,859
60,050	60,100	11,206	8,176	11,206	9,871
60,100	60,150	11,219	8,184	11,219	9,884
60,150	60,200	11,231	8,191	11,231	9,896
60,200	60,250	11,244	8,199	11,244	9,909
60,250	60,300	11,256	8,206	11,256	9,921
60,300	60,350	11,269	8,214	11,269	9,934
60,350	60,400	11,281	8,221	11,281	9,946
60,400	60,450	11,294	8,229	11,294	9,959
60,450	60,500	11,306	8,236	11,306	9,971
60,500	60,550	11,319	8,244	11,319	9,984
60,550	60,600	11,331	8,251	11,331	9,996
60,600	60,650	11,344	8,259	11,344	10,009
60,650	60,700	11,356	8,266	11,356	10,021
60,700	60,750	11,369	8,274	11,369	10,034
60,750	60,800	11,381	8,281	11,381	10,046
60,800	60,850	11,394	8,289	11,394	10,059
60,850	60,900	11,406	8,296	11,406	10,071
60,900	60,950	11,419	8,304	11,419	10,084
60,950	61,000	11,431	8,311	11,431	10,096
61,000					
61,000	61,050	11,444	8,319	11,444	10,109
61,050	61,100	11,456	8,326	11,456	10,121
61,100	61,150	11,469	8,334	11,469	10,134
61,150	61,200	11,481	8,341	11,481	10,146
61,200	61,250	11,494	8,349	11,494	10,159
61,250	61,300	11,506	8,356	11,506	10,171
61,300	61,350	11,519	8,364	11,519	10,184
61,350	61,400	11,531	8,371	11,531	10,196
61,400	61,450	11,544	8,379	11,544	10,209
61,450	61,500	11,556	8,386	11,556	10,221
61,500	61,550	11,569	8,394	11,569	10,234
61,550	61,600	11,581	8,401	11,581	10,246
61,600	61,650	11,594	8,409	11,594	10,259
61,650	61,700	11,606	8,416	11,606	10,271
61,700	61,750	11,619	8,424	11,619	10,284
61,750	61,800	11,631	8,431	11,631	10,296
61,800	61,850	11,644	8,439	11,644	10,309
61,850	61,900	11,656	8,446	11,656	10,321
61,900	61,950	11,669	8,454	11,669	10,334
61,950	62,000	11,681	8,461	11,681	10,346
62,000					
62,000	62,050	11,694	8,469	11,694	10,359
62,050	62,100	11,706	8,476	11,706	10,371
62,100	62,150	11,719	8,484	11,719	10,384
62,150	62,200	11,731	8,491	11,731	10,396
62,200	62,250	11,744	8,499	11,744	10,409
62,250	62,300	11,756	8,506	11,756	10,421
62,300	62,350	11,769	8,514	11,769	10,434
62,350	62,400	11,781	8,521	11,781	10,446
62,400	62,450	11,794	8,529	11,794	10,459
62,450	62,500	11,806	8,536	11,806	10,471
62,500	62,550	11,819	8,544	11,819	10,484
62,550	62,600	11,831	8,551	11,831	10,496
62,600	62,650	11,844	8,559	11,844	10,509
62,650	62,700	11,856	8,566	11,856	10,521
62,700	62,750	11,869	8,574	11,869	10,534
62,750	62,800	11,881	8,581	11,881	10,546
62,800	62,850	11,894	8,589	11,894	10,559
62,850	62,900	11,906	8,596	11,906	10,571
62,900	62,950	11,919	8,604	11,919	10,584
62,950	63,000	11,931	8,611	11,931	10,596
63,000					
63,000	63,050	11,944	8,619	11,944	10,609
63,050	63,100	11,956	8,626	11,956	10,621
63,100	63,150	11,969	8,634	11,969	10,634
63,150	63,200	11,981	8,641	11,981	10,646
63,200	63,250	11,994	8,649	11,994	10,659
63,250	63,300	12,006	8,656	12,006	10,671
63,300	63,350	12,019	8,664	12,019	10,684
63,350	63,400	12,031	8,671	12,031	10,696
63,400	63,450	12,044	8,679	12,044	10,709
63,450	63,500	12,056	8,686	12,056	10,721
63,500	63,550	12,069	8,694	12,069	10,734
63,550	63,600	12,081	8,701	12,081	10,746
63,600	63,650	12,094	8,709	12,094	10,759
63,650	63,700	12,106	8,716	12,106	10,771
63,700	63,750	12,119	8,724	12,119	10,784
63,750	63,800	12,131	8,731	12,131	10,796
63,800	63,850	12,144	8,739	12,144	10,809
63,850	63,900	12,156	8,746	12,156	10,821
63,900	63,950	12,169	8,754	12,169	10,834
63,950	64,000	12,181	8,761	12,181	10,846
64,000					
64,000	64,050	12,194	8,769	12,194	10,859
64,050	64,100	12,206	8,776	12,206	10,871
64,100	64,150	12,219	8,784	12,219	10,884
64,150	64,200	12,231	8,791	12,231	10,896
64,200	64,250	12,244	8,799	12,244	10,909
64,250	64,300	12,256	8,806	12,256	10,921
64,300	64,350	12,269	8,814	12,269	10,934
64,350	64,400	12,281	8,821	12,281	10,946
64,400	64,450	12,294	8,829	12,294	10,959
64,450	64,500	12,306	8,836	12,306	10,971
64,500	64,550	12,319	8,844	12,319	10,984
64,550	64,600	12,331	8,851	12,331	10,996
64,600	64,650	12,344	8,859	12,344	11,009
64,650	64,700	12,356	8,866	12,356	11,021
64,700	64,750	12,369	8,874	12,369	11,034
64,750	64,800	12,381	8,881	12,381	11,046
64,800	64,850	12,394	8,889	12,394	11,059
64,850	64,900	12,406	8,896	12,406	11,071
64,900	64,950	12,419	8,904	12,419	11,084
64,950	65,000	12,431	8,911	12,431	11,096
65,000					
65,000	65,050	12,444	8,919	12,444	11,109
65,050	65,100	12,456	8,926	12,456	11,121
65,100	65,150	12,469	8,934	12,469	11,134
65,150	65,200	12,481	8,941	12,481	11,146
65,200	65,250	12,494	8,949	12,494	11,159
65,250	65,300	12,506	8,956	12,506	11,171
65,300	65,350	12,519	8,964	12,519	11,184
65,350	65,400	12,531	8,971	12,531	11,196
65,400	65,450	12,544	8,979	12,544	11,209
65,450	65,500	12,556	8,986	12,556	11,221
65,500	65,550	12,569	8,994	12,569	11,234
65,550	65,600	12,581	9,001	12,581	11,246
65,600	65,650	12,594	9,009	12,594	11,259
65,650	65,700	12,606	9,016	12,606	11,271
65,700	65,750	12,619	9,024	12,619	11,284
65,750	65,800	12,631	9,031	12,631	11,296
65,800	65,850	12,644	9,039	12,644	11,309
65,850	65,900	12,656	9,046	12,656	11,321
65,900	65,950	12,669	9,054	12,669	11,334
65,950	66,000	12,681	9,061	12,681	11,346
66,000					
66,000	66,050	12,694	9,069	12,694	11,359
66,050	66,100	12,706	9,076	12,706	11,371
66,100	66,150	12,719	9,084	12,719	11,384
66,150	66,200	12,731	9,091	12,731	11,396
66,200	66,250	12,744	9,099	12,744	11,409
66,250	66,300	12,756	9,106	12,756	11,421
66,300	66,350	12,769	9,114	12,769	11,434
66,350	66,400	12,781	9,121	12,781	11,446
66,400	66,450	12,794	9,129	12,794	11,459
66,450	66,500	12,806	9,136	12,806	11,471
66,500	66,550	12,819	9,144	12,819	11,484
66,550	66,600	12,831	9,151	12,831	11,496
66,600	66,650	12,844	9,159	12,844	11,509
66,650	66,700	12,856	9,166	12,856	11,521
66,700	66,750	12,869	9,174	12,869	11,534
66,750	66,800	12,881	9,181	12,881	11,546
66,800	66,850	12,894	9,189	12,894	11,559
66,850	66,900	12,906	9,196	12,906	11,571
66,900	66,950	12,919	9,204	12,919	11,584
66,950	67,000	12,931	9,211	12,931	11,596
67,000					
67,000	67,050	12,944	9,219	12,944	11,609
67,050	67,100	12,956	9,226	12,956	11,621
67,100	67,150	12,969	9,234	12,969	11,634
67,150	67,200	12,981	9,241	12,981	11,646
67,200	67,250	12,994	9,249	12,994	11,659
67,250	67,300	13,006	9,256	13,006	11,671
67,300	67,350	13,019	9,264	13,019	11,684
67,350	67,400	13,031	9,271	13,031	11,696
67,400	67,450	13,044	9,279	13,044	11,709
67,450	67,500	13,056	9,286	13,056	11,721
67,500	67,550	13,069	9,294	13,069	11,734
67,550	67,600	13,081	9,301	13,081	11,746
67,600	67,650	13,094	9,309	13,094	11,759
67,650	67,700	13,106	9,316	13,106	11,771
67,700	67,750	13,119	9,324	13,119	11,784
67,750	67,800	13,131	9,331	13,131	11,796
67,800	67,850	13,144	9,339	13,144	11,809
67,850	67,900	13,156	9,346	13,156	11,821
67,900	67,950	13,169	9,356	13,169	11,834
67,950	68,000	13,181	9,369	13,181	11,846

*This column must also be used by a qualifying widow(er).

(Continued on next page)

2009 Tax Table–*Continued*

If line 43 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—			
68,000					
68,000	68,050	13,194	9,381	13,194	11,859
68,050	68,100	13,206	9,394	13,206	11,871
68,100	68,150	13,219	9,406	13,219	11,884
68,150	68,200	13,231	9,419	13,231	11,896
68,200	68,250	13,244	9,431	13,244	11,909
68,250	68,300	13,256	9,444	13,256	11,921
68,300	68,350	13,269	9,456	13,269	11,934
68,350	68,400	13,281	9,469	13,281	11,946
68,400	68,450	13,294	9,481	13,294	11,959
68,450	68,500	13,306	9,494	13,306	11,971
68,500	68,550	13,319	9,506	13,319	11,984
68,550	68,600	13,331	9,519	13,333	11,996
68,600	68,650	13,344	9,531	13,347	12,009
68,650	68,700	13,356	9,544	13,361	12,021
68,700	68,750	13,369	9,556	13,375	12,034
68,750	68,800	13,381	9,569	13,389	12,046
68,800	68,850	13,394	9,581	13,403	12,059
68,850	68,900	13,406	9,594	13,417	12,071
68,900	68,950	13,419	9,606	13,431	12,084
68,950	69,000	13,431	9,619	13,445	12,096
69,000					
69,000	69,050	13,444	9,631	13,459	12,109
69,050	69,100	13,456	9,644	13,473	12,121
69,100	69,150	13,469	9,656	13,487	12,134
69,150	69,200	13,481	9,669	13,501	12,146
69,200	69,250	13,494	9,681	13,515	12,159
69,250	69,300	13,506	9,694	13,529	12,171
69,300	69,350	13,519	9,706	13,543	12,184
69,350	69,400	13,531	9,719	13,557	12,196
69,400	69,450	13,544	9,731	13,571	12,209
69,450	69,500	13,556	9,744	13,585	12,221
69,500	69,550	13,569	9,756	13,599	12,234
69,550	69,600	13,581	9,769	13,613	12,246
69,600	69,650	13,594	9,781	13,627	12,259
69,650	69,700	13,606	9,794	13,641	12,271
69,700	69,750	13,619	9,806	13,655	12,284
69,750	69,800	13,631	9,819	13,669	12,296
69,800	69,850	13,644	9,831	13,683	12,309
69,850	69,900	13,656	9,844	13,697	12,321
69,900	69,950	13,669	9,856	13,711	12,334
69,950	70,000	13,681	9,869	13,725	12,346
70,000					
70,000	70,050	13,694	9,881	13,739	12,359
70,050	70,100	13,706	9,894	13,753	12,371
70,100	70,150	13,719	9,906	13,767	12,384
70,150	70,200	13,731	9,919	13,781	12,396
70,200	70,250	13,744	9,931	13,795	12,409
70,250	70,300	13,756	9,944	13,809	12,421
70,300	70,350	13,769	9,956	13,823	12,434
70,350	70,400	13,781	9,969	13,837	12,446
70,400	70,450	13,794	9,981	13,851	12,459
70,450	70,500	13,806	9,994	13,865	12,471
70,500	70,550	13,819	10,006	13,879	12,484
70,550	70,600	13,831	10,019	13,893	12,496
70,600	70,650	13,844	10,031	13,907	12,509
70,650	70,700	13,856	10,044	13,921	12,521
70,700	70,750	13,869	10,056	13,935	12,534
70,750	70,800	13,881	10,069	13,949	12,546
70,800	70,850	13,894	10,081	13,963	12,559
70,850	70,900	13,906	10,094	13,977	12,571
70,900	70,950	13,919	10,106	13,991	12,584
70,950	71,000	13,931	10,119	14,005	12,596

If line 43 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—			
71,000					
71,000	71,050	13,944	10,131	14,019	12,609
71,050	71,100	13,956	10,144	14,033	12,621
71,100	71,150	13,969	10,156	14,047	12,634
71,150	71,200	13,981	10,169	14,061	12,646
71,200	71,250	13,994	10,181	14,075	12,659
71,250	71,300	14,006	10,194	14,089	12,671
71,300	71,350	14,019	10,206	14,103	12,684
71,350	71,400	14,031	10,219	14,117	12,696
71,400	71,450	14,044	10,231	14,131	12,709
71,450	71,500	14,056	10,244	14,145	12,721
71,500	71,550	14,069	10,256	14,159	12,734
71,550	71,600	14,081	10,269	14,173	12,746
71,600	71,650	14,094	10,281	14,187	12,759
71,650	71,700	14,106	10,294	14,201	12,771
71,700	71,750	14,119	10,306	14,215	12,784
71,750	71,800	14,131	10,319	14,229	12,796
71,800	71,850	14,144	10,331	14,243	12,809
71,850	71,900	14,156	10,344	14,257	12,821
71,900	71,950	14,169	10,356	14,271	12,834
71,950	72,000	14,181	10,369	14,285	12,846
72,000					
72,000	72,050	14,194	10,381	14,299	12,859
72,050	72,100	14,206	10,394	14,313	12,871
72,100	72,150	14,219	10,406	14,327	12,884
72,150	72,200	14,231	10,419	14,341	12,896
72,200	72,250	14,244	10,431	14,355	12,909
72,250	72,300	14,256	10,444	14,369	12,921
72,300	72,350	14,269	10,456	14,383	12,934
72,350	72,400	14,281	10,469	14,397	12,946
72,400	72,450	14,294	10,481	14,411	12,959
72,450	72,500	14,306	10,494	14,425	12,971
72,500	72,550	14,319	10,506	14,439	12,984
72,550	72,600	14,331	10,519	14,453	12,996
72,600	72,650	14,344	10,531	14,467	13,009
72,650	72,700	14,356	10,544	14,481	13,021
72,700	72,750	14,369	10,556	14,495	13,034
72,750	72,800	14,381	10,569	14,509	13,046
72,800	72,850	14,394	10,581	14,523	13,059
72,850	72,900	14,406	10,594	14,537	13,071
72,900	72,950	14,419	10,606	14,551	13,084
72,950	73,000	14,431	10,619	14,565	13,096
73,000					
73,000	73,050	14,444	10,631	14,579	13,109
73,050	73,100	14,456	10,644	14,593	13,121
73,100	73,150	14,469	10,656	14,607	13,134
73,150	73,200	14,481	10,669	14,621	13,146
73,200	73,250	14,494	10,681	14,635	13,159
73,250	73,300	14,506	10,694	14,649	13,171
73,300	73,350	14,519	10,706	14,663	13,184
73,350	73,400	14,531	10,719	14,677	13,196
73,400	73,450	14,544	10,731	14,691	13,209
73,450	73,500	14,556	10,744	14,705	13,221
73,500	73,550	14,569	10,756	14,719	13,234
73,550	73,600	14,581	10,769	14,733	13,246
73,600	73,650	14,594	10,781	14,747	13,259
73,650	73,700	14,606	10,794	14,761	13,271
73,700	73,750	14,619	10,806	14,775	13,284
73,750	73,800	14,631	10,819	14,789	13,296
73,800	73,850	14,644	10,831	14,803	13,309
73,850	73,900	14,656	10,844	14,817	13,321
73,900	73,950	14,669	10,856	14,831	13,334
73,950	74,000	14,681	10,869	14,845	13,346

If line 43 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—			
74,000					
74,000	74,050	14,694	10,881	14,859	13,359
74,050	74,100	14,706	10,894	14,873	13,371
74,100	74,150	14,719	10,906	14,887	13,384
74,150	74,200	14,731	10,919	14,901	13,396
74,200	74,250	14,744	10,931	14,915	13,409
74,250	74,300	14,756	10,944	14,929	13,421
74,300	74,350	14,769	10,956	14,943	13,434
74,350	74,400	14,781	10,969	14,957	13,446
74,400	74,450	14,794	10,981	14,971	13,459
74,450	74,500	14,806	10,994	14,985	13,471
74,500	74,550	14,819	11,006	14,999	13,484
74,550	74,600	14,831	11,019	15,013	13,496
74,600	74,650	14,844	11,031	15,027	13,509
74,650	74,700	14,856	11,044	15,041	13,521
74,700	74,750	14,869	11,056	15,055	13,534
74,750	74,800	14,881	11,069	15,069	13,546
74,800	74,850	14,894	11,081	15,083	13,559
74,850	74,900	14,906	11,094	15,097	13,571
74,900	74,950	14,919	11,106	15,111	13,584
74,950	75,000	14,931	11,119	15,125	13,596
75,000					
75,000	75,050	14,944	11,131	15,139	13,609
75,050	75,100	14,956	11,144	15,153	13,621
75,100	75,150	14,969	11,156	15,167	13,634
75,150	75,200	14,981	11,169	15,181	13,646
75,200	75,250	14,994	11,181	15,195	13,659
75,250	75,300	15,006	11,194	15,209	13,671
75,300	75,350	15,019	11,206	15,223	13,684
75,350	75,400	15,031	11,219	15,237	13,696
75,400	75,450	15,044	11,231	15,251	13,709
75,450	75,500	15,056	11,244	15,265	13,721
75,500	75,550	15,069	11,256	15,279	13,734
75,550	75,600	15,081	11,269	15,293	13,746
75,600	75,650	15,094	11,281	15,307	13,759
75,650	75,700	15,106	11,294	15,321	13,771
75,700	75,750	15,119	11,306	15,335	13,784
75,750	75,800	15,131	11,319	15,349	13,796
75,800	75,850	15,144	11,331	15,363	13,809
75,850	75,900	15,156	11,344	15,377	13,821
75,900	75,950	15,169	11,356	15,391	13,834
75,950	76,000	15,181	11,369	15,405	13,846
76,000					
76,000	76,050	15,194	11,381	15,419	13,859
76,050	76,100	15,206	11,394	15,433	13,871
76,100	76,150	15,219	11,406	15,447	13,884
76,150	76,200	15,231	11,419	15,461	13,896
76,200	76,250	15,244	11,431	15,475	13,909
76,250	76,300	15,256	11,444	15,489	13,921
76,300	76,350	15,269	11,456	15,503	13,934
76,350	76,400	15,281	11,469	15,517	13,946
76,400	76,450	15,294	11,481	15,531	13,959
76,450	76,500	15,306	11,494	15,545	13,971
76,500	76,550	15,319	11,506	15,559	13,984
76,550	76,600	15,331	11,519	15,573	13,996
76,600	76,650	15,344	11,531	15,587	14,009
76,650	76,700	15,356	11,544	15,601	14,021
76,700	76,750	15,369	11,556	15,615	14,034
76,750	76,800	15,381	11,569	15,629	14,046
76,800	76,850	15,394	11,581	15,643	14,059
76,850	76,900	15,406	11,594	15,657	14,071
76,900	76,950	15,419	11,606	15,671	14,084
76,950	77,000	15,431	11,619	15,685	14,096

*This column must also be used by a qualifying widow(er).

(Continued on next page)

2009 Tax Table–*Continued*

If line 43 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—			
77,000					
77,000	77,050	15,444	11,631	15,699	14,109
77,050	77,100	15,456	11,644	15,713	14,121
77,100	77,150	15,469	11,656	15,727	14,134
77,150	77,200	15,481	11,669	15,741	14,146
77,200	77,250	15,494	11,681	15,755	14,159
77,250	77,300	15,506	11,694	15,769	14,171
77,300	77,350	15,519	11,706	15,783	14,184
77,350	77,400	15,531	11,719	15,797	14,196
77,400	77,450	15,544	11,731	15,811	14,209
77,450	77,500	15,556	11,744	15,825	14,221
77,500	77,550	15,569	11,756	15,839	14,234
77,550	77,600	15,581	11,769	15,853	14,246
77,600	77,650	15,594	11,781	15,867	14,259
77,650	77,700	15,606	11,794	15,881	14,271
77,700	77,750	15,619	11,806	15,895	14,284
77,750	77,800	15,631	11,819	15,909	14,296
77,800	77,850	15,644	11,831	15,923	14,309
77,850	77,900	15,656	11,844	15,937	14,321
77,900	77,950	15,669	11,856	15,951	14,334
77,950	78,000	15,681	11,869	15,965	14,346
78,000					
78,000	78,050	15,694	11,881	15,979	14,359
78,050	78,100	15,706	11,894	15,993	14,371
78,100	78,150	15,719	11,906	16,007	14,384
78,150	78,200	15,731	11,919	16,021	14,396
78,200	78,250	15,744	11,931	16,035	14,409
78,250	78,300	15,756	11,944	16,049	14,421
78,300	78,350	15,769	11,956	16,063	14,434
78,350	78,400	15,781	11,969	16,077	14,446
78,400	78,450	15,794	11,981	16,091	14,459
78,450	78,500	15,806	11,994	16,105	14,471
78,500	78,550	15,819	12,006	16,119	14,484
78,550	78,600	15,831	12,019	16,133	14,496
78,600	78,650	15,844	12,031	16,147	14,509
78,650	78,700	15,856	12,044	16,161	14,521
78,700	78,750	15,869	12,056	16,175	14,534
78,750	78,800	15,881	12,069	16,189	14,546
78,800	78,850	15,894	12,081	16,203	14,559
78,850	78,900	15,906	12,094	16,217	14,571
78,900	78,950	15,919	12,106	16,231	14,584
78,950	79,000	15,931	12,119	16,245	14,596
79,000					
79,000	79,050	15,944	12,131	16,259	14,609
79,050	79,100	15,956	12,144	16,273	14,621
79,100	79,150	15,969	12,156	16,287	14,634
79,150	79,200	15,981	12,169	16,301	14,646
79,200	79,250	15,994	12,181	16,315	14,659
79,250	79,300	16,006	12,194	16,329	14,671
79,300	79,350	16,019	12,206	16,343	14,684
79,350	79,400	16,031	12,219	16,357	14,696
79,400	79,450	16,044	12,231	16,371	14,709
79,450	79,500	16,056	12,244	16,385	14,721
79,500	79,550	16,069	12,256	16,399	14,734
79,550	79,600	16,081	12,269	16,413	14,746
79,600	79,650	16,094	12,281	16,427	14,759
79,650	79,700	16,106	12,294	16,441	14,771
79,700	79,750	16,119	12,306	16,455	14,784
79,750	79,800	16,131	12,319	16,469	14,796
79,800	79,850	16,144	12,331	16,483	14,809
79,850	79,900	16,156	12,344	16,497	14,821
79,900	79,950	16,169	12,356	16,511	14,834
79,950	80,000	16,181	12,369	16,525	14,846
80,000					
80,000	80,050	16,194	12,381	16,539	14,859
80,050	80,100	16,206	12,394	16,553	14,871
80,100	80,150	16,219	12,406	16,567	14,884
80,150	80,200	16,231	12,419	16,581	14,896
80,200	80,250	16,244	12,431	16,595	14,909
80,250	80,300	16,256	12,444	16,609	14,921
80,300	80,350	16,269	12,456	16,623	14,934
80,350	80,400	16,281	12,469	16,637	14,946
80,400	80,450	16,294	12,481	16,651	14,959
80,450	80,500	16,306	12,494	16,665	14,971
80,500	80,550	16,319	12,506	16,679	14,984
80,550	80,600	16,331	12,519	16,693	14,996
80,600	80,650	16,344	12,531	16,707	15,009
80,650	80,700	16,356	12,544	16,721	15,021
80,700	80,750	16,369	12,556	16,735	15,034
80,750	80,800	16,381	12,569	16,749	15,046
80,800	80,850	16,394	12,581	16,763	15,059
80,850	80,900	16,406	12,594	16,777	15,071
80,900	80,950	16,419	12,606	16,791	15,084
80,950	81,000	16,431	12,619	16,805	15,096
81,000					
81,000	81,050	16,444	12,631	16,819	15,109
81,050	81,100	16,456	12,644	16,833	15,121
81,100	81,150	16,469	12,656	16,847	15,134
81,150	81,200	16,481	12,669	16,861	15,146
81,200	81,250	16,494	12,681	16,875	15,159
81,250	81,300	16,506	12,694	16,889	15,171
81,300	81,350	16,519	12,706	16,903	15,184
81,350	81,400	16,531	12,719	16,917	15,196
81,400	81,450	16,544	12,731	16,931	15,209
81,450	81,500	16,556	12,744	16,945	15,221
81,500	81,550	16,569	12,756	16,959	15,234
81,550	81,600	16,581	12,769	16,973	15,246
81,600	81,650	16,594	12,781	16,987	15,259
81,650	81,700	16,606	12,794	17,001	15,271
81,700	81,750	16,619	12,806	17,015	15,284
81,750	81,800	16,631	12,819	17,029	15,296
81,800	81,850	16,644	12,831	17,043	15,309
81,850	81,900	16,656	12,844	17,057	15,321
81,900	81,950	16,669	12,856	17,071	15,334
81,950	82,000	16,681	12,869	17,085	15,346
82,000					
82,000	82,050	16,694	12,881	17,099	15,359
82,050	82,100	16,706	12,894	17,113	15,371
82,100	82,150	16,719	12,906	17,127	15,384
82,150	82,200	16,731	12,919	17,141	15,396
82,200	82,250	16,744	12,931	17,155	15,409
82,250	82,300	16,757	12,944	17,169	15,421
82,300	82,350	16,771	12,956	17,183	15,434
82,350	82,400	16,785	12,969	17,197	15,446
82,400	82,450	16,799	12,981	17,211	15,459
82,450	82,500	16,813	12,994	17,225	15,471
82,500	82,550	16,827	13,006	17,239	15,484
82,550	82,600	16,841	13,019	17,253	15,496
82,600	82,650	16,855	13,031	17,267	15,509
82,650	82,700	16,869	13,044	17,281	15,521
82,700	82,750	16,883	13,056	17,295	15,534
82,750	82,800	16,897	13,069	17,309	15,546
82,800	82,850	16,911	13,081	17,323	15,559
82,850	82,900	16,925	13,094	17,337	15,571
82,900	82,950	16,939	13,106	17,351	15,584
82,950	83,000	16,953	13,119	17,365	15,596
83,000					
83,000	83,050	16,967	13,131	17,379	15,609
83,050	83,100	16,981	13,144	17,393	15,621
83,100	83,150	16,995	13,156	17,407	15,634
83,150	83,200	17,009	13,169	17,421	15,646
83,200	83,250	17,023	13,181	17,435	15,659
83,250	83,300	17,037	13,194	17,449	15,671
83,300	83,350	17,051	13,206	17,463	15,684
83,350	83,400	17,065	13,219	17,477	15,696
83,400	83,450	17,079	13,231	17,491	15,709
83,450	83,500	17,093	13,244	17,505	15,721
83,500	83,550	17,107	13,256	17,519	15,734
83,550	83,600	17,121	13,269	17,533	15,746
83,600	83,650	17,135	13,281	17,547	15,759
83,650	83,700	17,149	13,294	17,561	15,771
83,700	83,750	17,163	13,306	17,575	15,784
83,750	83,800	17,177	13,319	17,589	15,796
83,800	83,850	17,191	13,331	17,603	15,809
83,850	83,900	17,205	13,344	17,617	15,821
83,900	83,950	17,219	13,356	17,631	15,834
83,950	84,000	17,233	13,369	17,645	15,846
84,000					
84,000	84,050	17,247	13,381	17,659	15,859
84,050	84,100	17,261	13,394	17,673	15,871
84,100	84,150	17,275	13,406	17,687	15,884
84,150	84,200	17,289	13,419	17,701	15,896
84,200	84,250	17,303	13,431	17,715	15,909
84,250	84,300	17,317	13,444	17,729	15,921
84,300	84,350	17,331	13,456	17,743	15,934
84,350	84,400	17,345	13,469	17,757	15,946
84,400	84,450	17,359	13,481	17,771	15,959
84,450	84,500	17,373	13,494	17,785	15,971
84,500	84,550	17,387	13,506	17,799	15,984
84,550	84,600	17,401	13,519	17,813	15,996
84,600	84,650	17,415	13,531	17,827	16,009
84,650	84,700	17,429	13,544	17,841	16,021
84,700	84,750	17,443	13,556	17,855	16,034
84,750	84,800	17,457	13,569	17,869	16,046
84,800	84,850	17,471	13,581	17,883	16,059
84,850	84,900	17,485	13,594	17,897	16,071
84,900	84,950	17,499	13,606	17,911	16,084
84,950	85,000	17,513	13,619	17,925	16,096
85,000					
85,000	85,050	17,527	13,631	17,939	16,109
85,050	85,100	17,541	13,644	17,953	16,121
85,100	85,150	17,555	13,656	17,967	16,134
85,150	85,200	17,569	13,669	17,981	16,146
85,200	85,250	17,583	13,681	17,995	16,159
85,250	85,300	17,597	13,694	18,009	16,171
85,300	85,350	17,611	13,706	18,023	16,184
85,350	85,400	17,625	13,719	18,037	16,196
85,400	85,450	17,639	13,731	18,051	16,209
85,450	85,500	17,653	13,744	18,065	16,221
85,500	85,550	17,667	13,756	18,079	16,234
85,550	85,600	17,681	13,769	18,093	16,246
85,600	85,650	17,695	13,781	18,107	16,259
85,650	85,700	17,709	13,794	18,121	16,271
85,700	85,750	17,723	13,806	18,135	16,284
85,750	85,800	17,737	13,819	18,149	16,296
85,800	85,850	17,751	13,831	18,163	16,309
85,850	85,900	17,765	13,844	18,177	16,321
85,900	85,950	17,779	13,856	18,191	16,334
85,950	86,000	17,793	13,869	18,205	16,346

*This column must also be used by a qualifying widow(er).

(Continued on next page)

2009 Tax Table–*Continued*

If line 43 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—			
86,000					
86,000	86,050	17,807	13,881	18,219	16,359
86,050	86,100	17,821	13,894	18,233	16,371
86,100	86,150	17,835	13,906	18,247	16,384
86,150	86,200	17,849	13,919	18,261	16,396
86,200	86,250	17,863	13,931	18,275	16,409
86,250	86,300	17,877	13,944	18,289	16,421
86,300	86,350	17,891	13,956	18,303	16,434
86,350	86,400	17,905	13,969	18,317	16,446
86,400	86,450	17,919	13,981	18,331	16,459
86,450	86,500	17,933	13,994	18,345	16,471
86,500	86,550	17,947	14,006	18,359	16,484
86,550	86,600	17,961	14,019	18,373	16,496
86,600	86,650	17,975	14,031	18,387	16,509
86,650	86,700	17,989	14,044	18,401	16,521
86,700	86,750	18,003	14,056	18,415	16,534
86,750	86,800	18,017	14,069	18,429	16,546
86,800	86,850	18,031	14,081	18,443	16,559
86,850	86,900	18,045	14,094	18,457	16,571
86,900	86,950	18,059	14,106	18,471	16,584
86,950	87,000	18,073	14,119	18,485	16,596
87,000					
87,000	87,050	18,087	14,131	18,499	16,609
87,050	87,100	18,101	14,144	18,513	16,621
87,100	87,150	18,115	14,156	18,527	16,634
87,150	87,200	18,129	14,169	18,541	16,646
87,200	87,250	18,143	14,181	18,555	16,659
87,250	87,300	18,157	14,194	18,569	16,671
87,300	87,350	18,171	14,206	18,583	16,684
87,350	87,400	18,185	14,219	18,597	16,696
87,400	87,450	18,199	14,231	18,611	16,709
87,450	87,500	18,213	14,244	18,625	16,721
87,500	87,550	18,227	14,256	18,639	16,734
87,550	87,600	18,241	14,269	18,653	16,746
87,600	87,650	18,255	14,281	18,667	16,759
87,650	87,700	18,269	14,294	18,681	16,771
87,700	87,750	18,283	14,306	18,695	16,784
87,750	87,800	18,297	14,319	18,709	16,796
87,800	87,850	18,311	14,331	18,723	16,809
87,850	87,900	18,325	14,344	18,737	16,821
87,900	87,950	18,339	14,356	18,751	16,834
87,950	88,000	18,353	14,369	18,765	16,846
88,000					
88,000	88,050	18,367	14,381	18,779	16,859
88,050	88,100	18,381	14,394	18,793	16,871
88,100	88,150	18,395	14,406	18,807	16,884
88,150	88,200	18,409	14,419	18,821	16,896
88,200	88,250	18,423	14,431	18,835	16,909
88,250	88,300	18,437	14,444	18,849	16,921
88,300	88,350	18,451	14,456	18,863	16,934
88,350	88,400	18,465	14,469	18,877	16,946
88,400	88,450	18,479	14,481	18,891	16,959
88,450	88,500	18,493	14,494	18,905	16,971
88,500	88,550	18,507	14,506	18,919	16,984
88,550	88,600	18,521	14,519	18,933	16,996
88,600	88,650	18,535	14,531	18,947	17,009
88,650	88,700	18,549	14,544	18,961	17,021
88,700	88,750	18,563	14,556	18,975	17,034
88,750	88,800	18,577	14,569	18,989	17,046
88,800	88,850	18,591	14,581	19,003	17,059
88,850	88,900	18,605	14,594	19,017	17,071
88,900	88,950	18,619	14,606	19,031	17,084
88,950	89,000	18,633	14,619	19,045	17,096

If line 43 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—			
89,000					
89,000	89,050	18,647	14,631	19,059	17,109
89,050	89,100	18,661	14,644	19,073	17,121
89,100	89,150	18,675	14,656	19,087	17,134
89,150	89,200	18,689	14,669	19,101	17,146
89,200	89,250	18,703	14,681	19,115	17,159
89,250	89,300	18,717	14,694	19,129	17,171
89,300	89,350	18,731	14,706	19,143	17,184
89,350	89,400	18,745	14,719	19,157	17,196
89,400	89,450	18,759	14,731	19,171	17,209
89,450	89,500	18,773	14,744	19,185	17,221
89,500	89,550	18,787	14,756	19,199	17,234
89,550	89,600	18,801	14,769	19,213	17,246
89,600	89,650	18,815	14,781	19,227	17,259
89,650	89,700	18,829	14,794	19,241	17,271
89,700	89,750	18,843	14,806	19,255	17,284
89,750	89,800	18,857	14,819	19,269	17,296
89,800	89,850	18,871	14,831	19,283	17,309
89,850	89,900	18,885	14,844	19,297	17,321
89,900	89,950	18,899	14,856	19,311	17,334
89,950	90,000	18,913	14,869	19,325	17,346
90,000					
90,000	90,050	18,927	14,881	19,339	17,359
90,050	90,100	18,941	14,894	19,353	17,371
90,100	90,150	18,955	14,906	19,367	17,384
90,150	90,200	18,969	14,919	19,381	17,396
90,200	90,250	18,983	14,931	19,395	17,409
90,250	90,300	18,997	14,944	19,409	17,421
90,300	90,350	19,011	14,956	19,423	17,434
90,350	90,400	19,025	14,969	19,437	17,446
90,400	90,450	19,039	14,981	19,451	17,459
90,450	90,500	19,053	14,994	19,465	17,471
90,500	90,550	19,067	15,006	19,479	17,484
90,550	90,600	19,081	15,019	19,493	17,496
90,600	90,650	19,095	15,031	19,507	17,509
90,650	90,700	19,109	15,044	19,521	17,521
90,700	90,750	19,123	15,056	19,535	17,534
90,750	90,800	19,137	15,069	19,549	17,546
90,800	90,850	19,151	15,081	19,563	17,559
90,850	90,900	19,165	15,094	19,577	17,571
90,900	90,950	19,179	15,106	19,591	17,584
90,950	91,000	19,193	15,119	19,605	17,596
91,000					
91,000	91,050	19,207	15,131	19,619	17,609
91,050	91,100	19,221	15,144	19,633	17,621
91,100	91,150	19,235	15,156	19,647	17,634
91,150	91,200	19,249	15,169	19,661	17,646
91,200	91,250	19,263	15,181	19,675	17,659
91,250	91,300	19,277	15,194	19,689	17,671
91,300	91,350	19,291	15,206	19,703	17,684
91,350	91,400	19,305	15,219	19,717	17,696
91,400	91,450	19,319	15,231	19,731	17,709
91,450	91,500	19,333	15,244	19,745	17,721
91,500	91,550	19,347	15,256	19,759	17,734
91,550	91,600	19,361	15,269	19,773	17,746
91,600	91,650	19,375	15,281	19,787	17,759
91,650	91,700	19,389	15,294	19,801	17,771
91,700	91,750	19,403	15,306	19,815	17,784
91,750	91,800	19,417	15,319	19,829	17,796
91,800	91,850	19,431	15,331	19,843	17,809
91,850	91,900	19,445	15,344	19,857	17,821
91,900	91,950	19,459	15,356	19,871	17,834
91,950	92,000	19,473	15,369	19,885	17,846

If line 43 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—			
92,000					
92,000	92,050	19,487	15,381	19,899	17,859
92,050	92,100	19,501	15,394	19,913	17,871
92,100	92,150	19,515	15,406	19,927	17,884
92,150	92,200	19,529	15,419	19,941	17,896
92,200	92,250	19,543	15,431	19,955	17,909
92,250	92,300	19,557	15,444	19,969	17,921
92,300	92,350	19,571	15,456	19,983	17,934
92,350	92,400	19,585	15,469	19,997	17,946
92,400	92,450	19,599	15,481	20,011	17,959
92,450	92,500	19,613	15,494	20,025	17,971
92,500	92,550	19,627	15,506	20,039	17,984
92,550	92,600	19,641	15,519	20,053	17,996
92,600	92,650	19,655	15,531	20,067	18,009
92,650	92,700	19,669	15,544	20,081	18,021
92,700	92,750	19,683	15,556	20,095	18,034
92,750	92,800	19,697	15,569	20,109	18,046
92,800	92,850	19,711	15,581	20,123	18,059
92,850	92,900	19,725	15,594	20,137	18,071
92,900	92,950	19,739	15,606	20,151	18,084
92,950	93,000	19,753	15,619	20,165	18,096
93,000					
93,000	93,050	19,767	15,631	20,179	18,109
93,050	93,100	19,781	15,644	20,193	18,121
93,100	93,150	19,795	15,656	20,207	18,134
93,150	93,200	19,809	15,669	20,221	18,146
93,200	93,250	19,823	15,681	20,235	18,159
93,250	93,300	19,837	15,694	20,249	18,171
93,300	93,350	19,851	15,706	20,263	18,184
93,350	93,400	19,865	15,719	20,277	18,196
93,400	93,450	19,879	15,731	20,291	18,209
93,450	93,500	19,893	15,744	20,305	18,221
93,500	93,550	19,907	15,756	20,319	18,234
93,550	93,600	19,921	15,769	20,333	18,246
93,600	93,650	19,935	15,781	20,347	18,259
93,650	93,700	19,949	15,794	20,361	18,271
93,700	93,750	19,963	15,806	20,375	18,284
93,750	93,800	19,977	15,819	20,389	18,296
93,800	93,850	19,991	15,831	20,403	18,309
93,850	93,900	20,005	15,844	20,417	18,321
93,900	93,950	20,019	15,856	20,431	18,334
93,950	94,000	20,033	15,869	20,445	18,346
94,000					
94,000	94,050	20,047	15,881	20,459	18,359
94,050	94,100	20,061	15,894	20,473	18,371
94,100	94,150	20,075	15,906	20,487	18,384
94,150	94,200	20,089	15,919	20,501	18,396
94,200	94,250	20,103	15,931	20,515	18,409
94,250	94,300	20,117	15,944	20,529	18,421
94,300	94,350	20,131	15,956	20,543	18,434
94,350	94,400	20,145	15,969	20,557	18,446
94,400	94,450	20,159	15,981	20,571	18,459
94,450	94,500	20,173	15,994	20,585	18,471
94,500	94,550	20,187	16,006	20,599	18,484
94,550	94,600	20,201	16,019	20,613	18,496
94,600	94,650	20,215	16,031	20,627	18,509
94,650	94,700	20,229	16,044	20,641	18,521
94,700	94,750	20,243	16,056	20,655	18,534
94,750	94,800	20,257	16,069	20,669	18,546
94,800	94,850	20,271	16,081	20,683	18,559
94,850	94,900	20,285	16,094	20,697	18,571
94,900	94,950	20,299	16,106	20,711	18,584
94,950	95,000	20,313	16,119	20,725	18,596

*This column must also be used by a qualifying widow(er).

(Continued on next page)

2009 Tax Table–*Continued*

If line 43 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—			
95,000					
95,000	95,050	20,327	16,131	20,739	18,609
95,050	95,100	20,341	16,144	20,753	18,621
95,100	95,150	20,355	16,156	20,767	18,634
95,150	95,200	20,369	16,169	20,781	18,646
95,200	95,250	20,383	16,181	20,795	18,659
95,250	95,300	20,397	16,194	20,809	18,671
95,300	95,350	20,411	16,206	20,823	18,684
95,350	95,400	20,425	16,219	20,837	18,696
95,400	95,450	20,439	16,231	20,851	18,709
95,450	95,500	20,453	16,244	20,865	18,721
95,500	95,550	20,467	16,256	20,879	18,734
95,550	95,600	20,481	16,269	20,893	18,746
95,600	95,650	20,495	16,281	20,907	18,759
95,650	95,700	20,509	16,294	20,921	18,771
95,700	95,750	20,523	16,306	20,935	18,784
95,750	95,800	20,537	16,319	20,949	18,796
95,800	95,850	20,551	16,331	20,963	18,809
95,850	95,900	20,565	16,344	20,977	18,821
95,900	95,950	20,579	16,356	20,991	18,834
95,950	96,000	20,593	16,369	21,005	18,846
96,000					
96,000	96,050	20,607	16,381	21,019	18,859
96,050	96,100	20,621	16,394	21,033	18,871
96,100	96,150	20,635	16,406	21,047	18,884
96,150	96,200	20,649	16,419	21,061	18,896
96,200	96,250	20,663	16,431	21,075	18,909
96,250	96,300	20,677	16,444	21,089	18,921
96,300	96,350	20,691	16,456	21,103	18,934
96,350	96,400	20,705	16,469	21,117	18,946
96,400	96,450	20,719	16,481	21,131	18,959
96,450	96,500	20,733	16,494	21,145	18,971
96,500	96,550	20,747	16,506	21,159	18,984
96,550	96,600	20,761	16,519	21,173	18,996
96,600	96,650	20,775	16,531	21,187	19,009
96,650	96,700	20,789	16,544	21,201	19,021
96,700	96,750	20,803	16,556	21,215	19,034
96,750	96,800	20,817	16,569	21,229	19,046
96,800	96,850	20,831	16,581	21,243	19,059
96,850	96,900	20,845	16,594	21,257	19,071
96,900	96,950	20,859	16,606	21,271	19,084
96,950	97,000	20,873	16,619	21,285	19,096
97,000					
97,000	97,050	20,887	16,631	21,299	19,109
97,050	97,100	20,901	16,644	21,313	19,121
97,100	97,150	20,915	16,656	21,327	19,134
97,150	97,200	20,929	16,669	21,341	19,146
97,200	97,250	20,943	16,681	21,355	19,159
97,250	97,300	20,957	16,694	21,369	19,171
97,300	97,350	20,971	16,706	21,383	19,184
97,350	97,400	20,985	16,719	21,397	19,196
97,400	97,450	20,999	16,731	21,411	19,209
97,450	97,500	21,013	16,744	21,425	19,221
97,500	97,550	21,027	16,756	21,439	19,234
97,550	97,600	21,041	16,769	21,453	19,246
97,600	97,650	21,055	16,781	21,467	19,259
97,650	97,700	21,069	16,794	21,481	19,271
97,700	97,750	21,083	16,806	21,495	19,284
97,750	97,800	21,097	16,819	21,509	19,296
97,800	97,850	21,111	16,831	21,523	19,309
97,850	97,900	21,125	16,844	21,537	19,321
97,900	97,950	21,139	16,856	21,551	19,334
97,950	98,000	21,153	16,869	21,565	19,346
98,000					
98,000	98,050	21,167	16,881	21,579	19,359
98,050	98,100	21,181	16,894	21,593	19,371
98,100	98,150	21,195	16,906	21,607	19,384
98,150	98,200	21,209	16,919	21,621	19,396
98,200	98,250	21,223	16,931	21,635	19,409
98,250	98,300	21,237	16,944	21,649	19,421
98,300	98,350	21,251	16,956	21,663	19,434
98,350	98,400	21,265	16,969	21,677	19,446
98,400	98,450	21,279	16,981	21,691	19,459
98,450	98,500	21,293	16,994	21,705	19,471
98,500	98,550	21,307	17,006	21,719	19,484
98,550	98,600	21,321	17,019	21,733	19,496
98,600	98,650	21,335	17,031	21,747	19,509
98,650	98,700	21,349	17,044	21,761	19,521
98,700	98,750	21,363	17,056	21,775	19,534
98,750	98,800	21,377	17,069	21,789	19,546
98,800	98,850	21,391	17,081	21,803	19,559
98,850	98,900	21,405	17,094	21,817	19,571
98,900	98,950	21,419	17,106	21,831	19,584
98,950	99,000	21,433	17,119	21,845	19,596
99,000					
99,000	99,050	21,447	17,131	21,859	19,609
99,050	99,100	21,461	17,144	21,873	19,621
99,100	99,150	21,475	17,156	21,887	19,634
99,150	99,200	21,489	17,169	21,901	19,646
99,200	99,250	21,503	17,181	21,915	19,659
99,250	99,300	21,517	17,194	21,929	19,671
99,300	99,350	21,531	17,206	21,943	19,684
99,350	99,400	21,545	17,219	21,957	19,696
99,400	99,450	21,559	17,231	21,971	19,709
99,450	99,500	21,573	17,244	21,985	19,721
99,500	99,550	21,587	17,256	21,999	19,734
99,550	99,600	21,601	17,269	22,013	19,746
99,600	99,650	21,615	17,281	22,027	19,759
99,650	99,700	21,629	17,294	22,041	19,771
99,700	99,750	21,643	17,306	22,055	19,784
99,750	99,800	21,657	17,319	22,069	19,796
99,800	99,850	21,671	17,331	22,083	19,809
99,850	99,900	21,685	17,344	22,097	19,821
99,900	99,950	21,699	17,356	22,111	19,834
99,950	100,000	21,713	17,369	22,125	19,846

$100,000 or over — use the Tax Rate Schedules on page A-2

*This column must also be used by a qualifying widow(er).

Income Tax Rates—Estates and Trusts

Tax Year 2009

Taxable Income		The Tax Is:	
Over—	But not Over—		Of the Amount Over—
$ 0	$ 2,300	15%	$ 0
2,300	5,350	$ 345.00 + 25%	2,300
5,350	8,200	1,107.50 + 28%	5,350
8,200	11,150	1,905.50 + 33%	8,200
11,150	.....	2,879.00 + 35%	11,150

Tax Year 2010

Taxable Income		The Tax Is:	
Over—	But not Over—		Of the Amount Over—
$ 0	$ 2,300	15%	$ 0
2,300	5,350	$ 345.00 + 25%	2,300
5,350	8,200	1,107.50 + 28%	5,350
8,200	11,200	1,905.50 + 33%	8,200
11,200	.....	2,895.50 + 35%	11,200

Income Tax Rates—Corporations

Taxable Income		Tax Is:	
Over—	But not Over—		Of the Amount Over—
$ 0	$ 50,000	15%	$ 0
50,000	75,000	$ 7,500 + 25%	50,000
75,000	100,000	13,750 + 34%	75,000
100,000	335,000	22,250 + 39%	100,000
335,000	10,000,000	113,900 + 34%	335,000
10,000,000	15,000,000	3,400,000 + 35%	10,000,000
15,000,000	18,333,333	5,150,000 + 38%	15,000,000
18,333,333	.....	35%	0

Unified Transfer Tax Rates

For Gifts Made and for Deaths After 1983 and Before 2002

If the Amount with Respect to Which the Tentative Tax to Be Computed Is:	The Tentative Tax Is:
Not over $10,000	18 percent of such amount.
Over $10,000 but not over $20,000	$1,800, plus 20 percent of the excess of such amount over $10,000.
Over $20,000 but not over $40,000	$3,800, plus 22 percent of the excess of such amount over $20,000.
Over $40,000 but not over $60,000	$8,200, plus 24 percent of the excess of such amount over $40,000.
Over $60,000 but not over $80,000	$13,000, plus 26 percent of the excess of such amount over $60,000.
Over $80,000 but not over $100,000	$18,200, plus 28 percent of the excess of such amount over $80,000.
Over $100,000 but not over $150,000	$23,800, plus 30 percent of the excess of such amount over $100,000.
Over $150,000 but not over $250,000	$38,800, plus 32 percent of the excess of such amount over $150,000.
Over $250,000 but not over $500,000	$70,800, plus 34 percent of the excess of such amount over $250,000.
Over $500,000 but not over $750,000	$155,800, plus 37 percent of the excess of such amount over $500,000.
Over $750,000 but not over $1,000,000	$248,300, plus 39 percent of the excess of such amount over $750,000.
Over $1,000,000 but not over $1,250,000	$345,800, plus 41 percent of the excess of such amount over $1,000,000.
Over $1,250,000 but not over $1,500,000	$448,300, plus 43 percent of the excess of such amount over $1,250,000.
Over $1,500,000 but not over $2,000,000	$555,800, plus 45 percent of the excess of such amount over $1,500,000.
Over $2,000,000 but not over $2,500,000	$780,800, plus 49 percent of the excess of such amount over $2,000,000.
Over $2,500,000 but not over $3,000,000	$1,025,800, plus 53 percent of the excess of such amount over $2,500,000.
Over $3,000,000*	$1,290,800, plus 55 percent of the excess of such amount over $3,000,000.

*For large taxable transfers (generally in excess of $10 million) there is a phaseout of the graduated rates and the unified tax credit.

Unified Transfer Tax Rates

For Gifts Made and for Deaths in 2002

If the Amount with Respect to Which the Tentative Tax to Be Computed Is:	The Tentative Tax Is:
Not over $10,000	18 percent of such amount.
Over $10,000 but not over $20,000	$1,800, plus 20 percent of the excess of such amount over $10,000.
Over $20,000 but not over $40,000	$3,800, plus 22 percent of the excess of such amount over $20,000.
Over $40,000 but not over $60,000	$8,200, plus 24 percent of the excess of such amount over $40,000.
Over $60,000 but not over $80,000	$13,000, plus 26 percent of the excess of such amount over $60,000.
Over $80,000 but not over $100,000	$18,200, plus 28 percent of the excess of such amount over $80,000.
Over $100,000 but not over $150,000	$23,800, plus 30 percent of the excess of such amount over $100,000.
Over $150,000 but not over $250,000	$38,800, plus 32 percent of the excess of such amount over $150,000.
Over $250,000 but not over $500,000	$70,800, plus 34 percent of the excess of such amount over $250,000.
Over $500,000 but not over $750,000	$155,800, plus 37 percent of the excess of such amount over $500,000.
Over $750,000 but not over $1,000,000	$248,300, plus 39 percent of the excess of such amount over $750,000.
Over $1,000,000 but not over $1,250,000	$345,800, plus 41 percent of the excess of such amount over $1,000,000.
Over $1,250,000 but not over $1,500,000	$448,300, plus 43 percent of the excess of such amount over $1,250,000.
Over $1,500,000 but not over $2,000,000	$555,800, plus 45 percent of the excess of such amount over $1,500,000.
Over $2,000,000 but not over $2,500,000	$780,800, plus 49 percent of the excess of such amount over $2,000,000.
Over $2,500,000	$1,025,800, plus 50 percent of the excess of such amount over $2,500,000.

Unified Transfer Tax Rates

For Gifts Made and for Deaths in 2003

If the Amount with Respect to Which the Tentative Tax to Be Computed Is:	The Tentative Tax Is:
Not over $10,000	18 percent of such amount.
Over $10,000 but not over $20,000	$1,800, plus 20 percent of the excess of such amount over $10,000.
Over $20,000 but not over $40,000	$3,800, plus 22 percent of the excess of such amount over $20,000.
Over $40,000 but not over $60,000	$8,200, plus 24 percent of the excess of such amount over $40,000.
Over $60,000 but not over $80,000	$13,000, plus 26 percent of the excess of such amount over $60,000.
Over $80,000 but not over $100,000	$18,200, plus 28 percent of the excess of such amount over $80,000.
Over $100,000 but not over $150,000	$23,800, plus 30 percent of the excess of such amount over $100,000.
Over $150,000 but not over $250,000	$38,800, plus 32 percent of the excess of such amount over $150,000.
Over $250,000 but not over $500,000	$70,800, plus 34 percent of the excess of such amount over $250,000.
Over $500,000 but not over $750,000	$155,800, plus 37 percent of the excess of such amount over $500,000.
Over $750,000 but not over $1,000,000	$248,300, plus 39 percent of the excess of such amount over $750,000.
Over $1,000,000 but not over $1,250,000	$345,800, plus 41 percent of the excess of such amount over $1,000,000.
Over $1,250,000 but not over $1,500,000	$448,300, plus 43 percent of the excess of such amount over $1,250,000.
Over $1,500,000 but not over $2,000,000	$555,800, plus 45 percent of the excess of such amount over $1,500,000.
Over $2,000,000	$780,800, plus 49 percent of the excess of such amount over $2,000,000.

For Gifts Made and for Deaths in 2004

(For amounts not over $2,000,000, see rates for 2003 above)	
Over $2,000,000	$780,800, plus 48 percent of the excess of such amount over $2,000,000.

For Gifts Made and for Deaths in 2005

(For amounts not over $2,000,000, see rates for 2003 above)	
Over $2,000,000	$780,800, plus 47 percent of the excess of such amount over $2,000,000.

For Gifts Made and for Deaths in 2006

(For amounts not over $2,000,000, see rates for 2003 above)	
Over $2,000,000	$780,800, plus 46 percent of the excess of such amount over $2,000,000.

Unified Transfer Tax Rates

For Gifts Made and for Deaths in 2007—2009

If the Amount with Respect to Which the Tentative Tax to Be Computed Is:	The Tentative Tax Is:
Not over $10,000	18 percent of such amount.
Over $10,000 but not over $20,000	$1,800, plus 20 percent of the excess of such amount over $10,000.
Over $20,000 but not over $40,000	$3,800, plus 22 percent of the excess of such amount over $20,000.
Over $40,000 but not over $60,000	$8,200, plus 24 percent of the excess of such amount over $40,000.
Over $60,000 but not over $80,000	$13,000, plus 26 percent of the excess of such amount over $60,000.
Over $80,000 but not over $100,000	$18,200, plus 28 percent of the excess of such amount over $80,000.
Over $100,000 but not over $150,000	$23,800, plus 30 percent of the excess of such amount over $100,000.
Over $150,000 but not over $250,000	$38,800, plus 32 percent of the excess of such amount over $150,000.
Over $250,000 but not over $500,000	$70,800, plus 34 percent of the excess of such amount over $250,000.
Over $500,000 but not over $750,000	$155,800, plus 37 percent of the excess of such amount over $500,000.
Over $750,000 but not over $1,000,000	$248,300, plus 39 percent of the excess of such amount over $750,000.
Over $1,000,000 but not over $1,250,000	$345,800, plus 41 percent of the excess of such amount over $1,000,000.
Over $1,250,000 but not over $1,500,000	$448,300, plus 43 percent of the excess of such amount over $1,250,000.
Over $1,500,000	$555,800, plus 45 percent of the excess of such amount over $1,500,000.

2009 Optional Sales Tax Tables

When Used

The election to deduct state and local general sales taxes requires that the taxpayer forgo any deduction for state and local income taxes. Whether this is advisable or not depends on a comparison of the amounts involved. In making the choice, however, the outcome could be influenced by the additional sales tax incurred due to certain "big ticket" purchases that were made. For example, a taxpayer who chose to deduct state and local income taxes for 2008 might well prefer the sales tax deduction in 2009 if a new boat was purchased or home improvements were made during the year. To make the sales tax election, the taxpayer must enter the amount on Schedule A, line 5, and check box b.

For 2009, the sales tax on the purchase of certain vehicles (e.g., car, SUVs, motorcycles) can be claimed *in addition to* state and local income taxes. (As to which purchases qualify, see the discussion in Chapter 3 in connection with various forms of the standard deduction.) In terms of reporting on Schedule A, line 5a is checked and both lines 5 and 7 are completed. In such cases, other sales taxes cannot be claimed.

If the sales tax election is made, the amount of the deduction can be determined by use of the *actual expense method* or the *optional sales tax tables* issued by the IRS. The actual expense method can be used only when the taxpayer has actual receipts to support the deduction claimed. In the absence of receipts, the usual case with most taxpayers, resorting to the optional sales tax tables is necessary. Under neither method, however, is the purchase of items used in a taxpayer's trade or business to be considered.

Adjustments Necessary

The optional sales tax tables are based on a number of assumptions that require adjustments to be made. As the starting point for the use of the tables is AGI, nontaxable receipts have not been included. Examples of receipts that should be added include: tax-exempt interest, veterans' benefits, nontaxable combat pay, public assistance payments, workers' compensation, nontaxable Social Security and other retirement benefits. But do not include any large nontaxable items that are not likely to be spent. For example, a $100,000 inheritance should not be added if it was invested in a certificate of deposit.

The tables represent the sales tax on the average (and recurring) expenditures based on level of income by family size and do not include exceptional purchases. Therefore, add to the table amount any sales taxes on major purchases (such as motor vehicles, aircraft, boats, and home building materials, etc.).

When the optional sales tax tables are utilized, special adjustments may be needed when a taxpayer has lived in more than one taxing jurisdiction (e.g., state, county, city) during the year. The adjustments involve apportionment of taxes based on days involved and are illustrated in Instructions for Schedule A (Form 1040), pages A-3 to A-5.

Local Sales Taxes

Local sales taxes (i.e., those imposed by counties, cities, transit authorities) may or may not require a separate determination. In those states where they are not imposed, no further computations are necessary. This is also the case where the local taxes are uniform and are incorporated into the state sales tax table. In other situations, another step is necessary to arrive at the optional sales tax table deduction. Depending on where the taxpayer lives, one of two procedures needs to be used. In one procedure, the local sales tax is arrived at by using the **state table** amount—see the Example 1 worksheet. In the other procedure, special **local tables** issued by the IRS for enumerated state and local jurisdictions are modified (if necessary) and used—see the Example 2 worksheet.

Use Illustrated

EXAMPLE 1 The Archers file a joint return for 2009 reflecting AGI of $88,000 and claiming three exemptions. They have tax-exempt interest of $3,000, and during the year they incurred sales tax of $1,650 on the purchase of an automobile for their dependent teenage son. They live in Bellaire, Texas, where the general sales tax rates are 6.25% for state and 2% for local. Since the IRS *has not issued* optional local sales tax tables for Texas, use the Worksheet below to arrive at the Archers' general sales tax deduction of $3,111.

Sales Tax Deduction Worksheet
(To be used when *no* IRS Optional Local Sales Tax Table Available)

Adjusted Gross Income (AGI) as listed on line 38 of Form 1040		$88,000
Add nontaxable items		3,000
Table income to be used for purposes of line 1 below		$91,000
1. Use table income to determine table amount—go to state of residence and find applicable range of table income and exemption column* for *state* sales tax		$ 1,107
2a. Enter local general sales tax rate	2.0	
2b. Enter state general sales tax rate	6.25	
2c. Divide 2a by 2b	0.32	
2d. Multiply line 1 by line 2c for the local sales tax		354
3. Enter general sales tax on large purchases		1,650
4. Deduction for general sales tax (add lines 1 + 2d + 3) and report on line 5 of Schedule A of Form 1040		$ 3,111

*Use total of personal and dependency exemptions as reported in item 6d of Form 1040.

EXAMPLE 2 The Hardys file a joint return for 2009, reporting AGI of $40,000 and claiming four exemptions (two personal and two dependency). They received $30,000 in nontaxable pension benefits. Although the Hardys do not keep sales tax receipts, they can prove that they paid $4,800 in sales tax on the purchase of a new boat in 2009. The Hardys are residents of Georgia and live in a jurisdiction that imposes a 2% local sales tax. Since the IRS *has issued* optional local sales tax tables for Georgia, use the Worksheet below to arrive at the Hardys' general sales tax deduction of $5,655.

Sales Tax Deduction Worksheet
[To be used for Alaska, Arizona, Arkansas, California (Los Angeles County), Colorado, Georgia, Illinois, Louisiana, Missouri, New York, North Carolina, South Carolina, Tennessee, Utah, and Virginia]

Adjusted Gross Income (AGI) as listed on line 38 of Form 1040		$40,000
Add nontaxable income		30,000
Table income to be used for purpose of line 1 below		$70,000
1. Use the table income to determine *state* sales tax amount—go to table for state of residence and find applicable income range and exemption column*		$ 523
2a. Enter local general sales tax rate	2.0	
2b. Enter IRS *local* sales tax table amount (based on 1%)	$166	
2c. Multiply line 2b by 2a for the local sales tax		332
3. Enter general sales tax on large purchases		4,800
4. Deduction for general sales tax (add lines 1 + 2c + 3) and report on line 5 of Schedule A of Form 1040		$ 5,655

*Use total of personal and dependency exemptions as reported in item 6d of Form 1040

2009 Optional State and Certain Local Sales Tax Tables

Income		Exemptions						Exemptions						Exemptions						Exemptions						Exemptions					
At least	But less than	1	2	3	4	5	Over 5	1	2	3	4	5	Over 5	1	2	3	4	5	Over 5	1	2	3	4	5	Over 5	1	2	3	4	5	Over 5
Alabama							**4.0000%**	**Arizona**					**5.6000%**	**Arkansas**					**6.0000%**	**California**[1, 2]					**8.0034%**	**Colorado**					**2.9000%**
$0	$20,000	203	239	264	282	298	319	219	237	249	258	265	274	287	319	340	356	368	386	285	309	323	334	343	355	105	114	119	123	127	131
20,000	30,000	310	362	397	424	446	477	364	393	412	425	436	451	475	526	559	584	604	631	482	519	542	559	573	591	171	184	193	200	205	212
30,000	40,000	365	425	465	496	521	557	443	478	499	516	529	546	574	635	674	704	727	760	589	633	660	681	697	719	206	223	233	240	246	254
40,000	50,000	413	479	524	558	586	626	514	553	577	596	610	630	662	731	775	809	835	872	686	736	767	790	808	833	239	257	268	276	283	292
50,000	60,000	458	530	578	615	645	688	579	623	650	670	686	708	742	818	867	904	934	975	776	831	865	891	911	939	269	288	301	310	317	327
60,000	70,000	500	576	627	667	700	746	641	688	718	739	757	781	816	899	952	992	1025	1069	862	921	958	986	1008	1038	297	318	331	341	349	360
70,000	80,000	540	621	675	717	752	800	702	752	783	807	825	851	887	976	1034	1077	1111	1159	945	1009	1049	1078	1102	1134	324	347	361	372	380	392
80,000	90,000	578	663	720	764	801	852	759	812	846	871	890	917	954	1049	1110	1156	1193	1243	1025	1092	1135	1166	1191	1226	351	375	390	401	410	422
90,000	100,000	615	704	763	809	848	901	815	871	906	932	953	982	1017	1118	1183	1231	1270	1324	1102	1174	1218	1251	1278	1314	376	401	417	429	438	451
100,000	120,000	666	759	822	870	910	967	891	951	988	1016	1039	1069	1103	1211	1280	1332	1374	1431	1208	1284	1332	1367	1395	1434	411	438	454	467	477	491
120,000	140,000	737	836	903	955	998	1059	999	1064	1105	1135	1159	1192	1222	1339	1415	1472	1518	1580	1358	1441	1493	1531	1562	1604	461	490	508	521	532	547
140,000	160,000	801	906	977	1032	1077	1141	1098	1167	1210	1242	1268	1303	1327	1454	1535	1596	1645	1712	1496	1584	1639	1680	1713	1758	506	537	556	570	582	597
160,000	180,000	868	978	1053	1110	1158	1225	1200	1273	1319	1353	1380	1418	1434	1569	1656	1721	1774	1846	1638	1731	1790	1834	1869	1916	554	586	606	621	633	650
180,000	200,000	930	1045	1122	1183	1232	1302	1295	1372	1420	1456	1485	1524	1532	1675	1767	1835	1891	1967	1771	1869	1931	1977	2014	2064	598	631	653	668	681	698
200,000	or more	1271	1407	1499	1571	1630	1713	1816	1910	1970	2014	2050	2099	2039	2221	2337	2424	2495	2591	2504	2624	2701	2757	2803	2865	842	882	908	927	943	963
Income		**Connecticut**					**6.0000%**	**District of Columbia**[1]					**5.8130%**	**Florida**					**6.0000%**	**Georgia**					**4.0000%**	**Hawaii**					**4.0000%**
$0	$20,000	216	229	238	244	249	256	177	188	194	199	203	208	228	249	263	272	280	291	147	160	169	175	179	186	245	280	302	319	333	353
20,000	30,000	369	392	406	416	424	435	303	320	330	337	343	352	385	419	440	456	469	486	240	260	272	281	289	299	388	440	474	500	521	551
30,000	40,000	452	479	496	508	518	531	373	393	405	414	421	430	471	512	537	556	571	591	290	313	328	339	347	359	462	523	562	593	618	652
40,000	50,000	526	557	576	590	601	616	436	458	472	482	490	501	549	594	623	644	662	685	335	361	377	389	399	412	526	594	639	673	700	739
50,000	60,000	593	628	649	665	677	694	495	519	534	546	554	566	621	671	703	727	746	771	377	405	423	436	447	461	583	658	707	745	775	817
60,000	70,000	656	694	717	735	748	766	550	577	593	605	615	628	689	744	778	804	824	852	416	447	466	480	492	507	637	718	771	811	844	889
70,000	80,000	717	758	783	802	816	836	604	633	651	664	674	688	755	814	851	878	901	931	454	487	507	523	535	552	687	774	830	873	908	957
80,000	90,000	774	818	845	865	880	901	656	686	705	719	730	745	819	881	920	950	973	1005	491	525	547	563	576	594	735	826	886	932	969	1020
90,000	100,000	829	875	904	925	942	964	706	738	758	773	784	800	880	946	987	1018	1043	1077	527	563	586	602	616	635	780	876	939	987	1026	1080
100,000	120,000	902	952	983	1006	1024	1048	774	808	830	845	858	874	964	1034	1078	1112	1138	1175	575	614	638	656	670	690	840	943	1010	1061	1102	1160
120,000	140,000	1005	1060	1094	1119	1139	1166	871	908	931	948	962	980	1083	1159	1207	1244	1273	1312	645	686	712	731	747	768	923	1035	1107	1162	1208	1270
140,000	160,000	1096	1156	1193	1220	1241	1270	959	999	1023	1042	1056	1075	1191	1273	1325	1363	1394	1437	708	752	779	800	816	839	997	1116	1193	1252	1300	1367
160,000	180,000	1189	1254	1293	1322	1345	1376	1049	1092	1118	1137	1153	1174	1303	1390	1445	1486	1519	1565	774	820	849	870	888	912	1071	1197	1280	1342	1393	1464
180,000	200,000	1274	1343	1385	1416	1440	1473	1133	1178	1206	1227	1243	1265	1408	1499	1557	1601	1636	1683	835	883	914	936	955	979	1139	1272	1358	1424	1478	1552
200,000	or more	1718	1807	1862	1902	1933	1976	1590	1647	1681	1707	1727	1754	1982	2096	2168	2222	2265	2325	1174	1232	1269	1296	1318	1349	1487	1652	1759	1841	1907	1999
Income		**Idaho**					**6.0000%**	**Illinois**					**6.2500%**	**Indiana**					**7.0000%**	**Iowa**					**6.0000%**	**Kansas**					**5.3000%**
$0	$20,000	300	353	388	415	437	469	233	259	276	289	299	314	280	307	325	338	348	363	255	279	294	305	313	326	285	332	364	389	410	438
20,000	30,000	466	544	596	636	670	716	376	416	442	461	477	498	454	496	523	544	560	582	433	471	495	513	527	547	453	525	574	612	643	686
30,000	40,000	553	643	703	750	788	842	453	500	530	552	570	595	547	597	628	652	671	697	528	574	603	624	641	665	540	625	682	726	762	812
40,000	50,000	630	730	797	849	892	951	522	574	607	633	653	681	628	685	720	747	768	798	612	665	697	722	742	768	616	712	775	824	865	921
50,000	60,000	700	809	882	939	985	1050	586	643	680	707	729	760	703	765	805	834	857	890	690	748	784	812	834	863	685	790	860	913	958	1020
60,000	70,000	766	883	961	1022	1072	1142	647	708	747	777	801	833	773	840	883	914	940	975	762	825	865	895	919	951	749	862	937	995	1043	1110
70,000	80,000	830	954	1037	1101	1155	1229	706	771	813	844	869	904	840	912	958	992	1019	1056	831	899	943	975	1001	1036	810	930	1011	1073	1124	1195
80,000	90,000	890	1021	1109	1176	1232	1311	763	831	875	908	935	972	904	980	1028	1064	1093	1133	896	969	1015	1050	1077	1115	867	994	1079	1145	1199	1275
90,000	100,000	949	1086	1178	1248	1307	1389	817	889	935	970	998	1037	965	1045	1096	1134	1164	1206	959	1036	1085	1122	1151	1191	921	1056	1145	1214	1271	1351
100,000	120,000	1028	1173	1270	1345	1407	1494	892	968	1017	1054	1084	1125	1046	1132	1187	1227	1260	1304	1042	1126	1179	1218	1249	1292	994	1137	1232	1306	1366	1451
120,000	140,000	1140	1296	1400	1481	1548	1641	999	1080	1133	1173	1205	1249	1161	1254	1313	1357	1393	1441	1159	1251	1309	1352	1386	1433	1095	1249	1353	1432	1498	1590
140,000	160,000	1242	1406	1517	1603	1673	1772	1096	1183	1238	1280	1314	1361	1264	1364	1427	1474	1512	1563	1264	1363	1425	1471	1508	1559	1184	1349	1459	1544	1614	1712
160,000	180,000	1346	1520	1637	1727	1802	1906	1197	1288	1347	1391	1427	1477	1368	1475	1542	1592	1632	1687	1370	1475	1542	1592	1632	1686	1274	1449	1566	1656	1731	1834
180,000	200,000	1444	1626	1748	1842	1920	2030	1292	1387	1449	1495	1533	1584	1465	1577	1647	1700	1743	1801	1467	1579	1650	1702	1745	1802	1357	1541	1664	1758	1837	1946
200,000	or more	1977	2196	2343	2457	2552	2684	1816	1930	2003	2059	2105	2167	1972	2112	2201	2268	2321	2394	1971	2116	2207	2275	2329	2403	1781	2010	2163	2280	2377	2513
Income		**Kentucky**					**6.0000%**	**Louisiana**					**4.0000%**	**Maine**					**5.0000%**	**Maryland**					**6.0000%**	**Massachusetts**[1]					**5.5240%**
$0	$20,000	220	242	257	268	276	288	159	172	180	186	191	198	149	159	166	170	174	179	215	236	250	261	269	280	166	178	186	191	196	202
20,000	30,000	363	399	421	438	451	470	271	292	306	316	324	334	252	268	278	285	291	299	349	382	402	418	431	448	269	288	299	308	315	324
30,000	40,000	442	483	510	529	545	567	333	358	374	386	395	408	309	328	340	348	355	365	421	460	484	502	517	537	326	347	361	370	378	389
40,000	50,000	512	559	588	611	629	653	388	416	435	448	459	473	361	382	396	405	413	423	487	529	557	577	594	616	378	401	416	426	435	447
50,000	60,000	577	629	661	686	706	733	439	471	491	506	517	534	410	433	448	458	467	478	548	594	624	646	664	689	426	451	467	479	488	501
60,000	70,000	639	695	730	756	778	807	487	521	543	559	572	590	456	481	497	508	518	530	606	656	688	711	731	757	472	498	515	528	538	551
70,000	80,000	699	759	796	825	848	879	533	570	594	611	625	644	502	528	545	557	567	580	662	715	749	775	795	823	517	545	562	576	586	601
80,000	90,000	757	820	860	890	914	947	577	617	642	661	676	696	545	574	591	604	615	629	717	773	808	835	857	886	560	589	607	621	632	647
90,000	100,000	813	879	921	953	978	1013	620	662	689	708	724	745	588	618	636	650	661	675	770	828	866	894	916	947	602	632	651	666	677	693
100,000	120,000	889	959	1004	1038	1065	1102	677	723	751	772	789	812	646	678	697	712	723	739	843	904	943	973	997	1030	659	691	711	726	738	755
120,000	140,000	997	1074	1122	1159	1188	1229	759	808	839	862	881	906	730	763	785	800	813	830	947	1013	1055	1087	1112	1147	742	775	796	812	825	843
140,000	160,000	1097	1178	1229	1268	1300	1343	832	885	919	944	963	990	806	842	864	881	894	912	1043	1112	1157	1190	1217	1254	817	852	874	891	904	923
160,000	180,000	1199	1285	1340	1381	1415	1460	907	964	1000	1027	1048	1077	886	924	947	965	979	998	1143	1216	1262	1297	1326	1365	896	932	955	973	987	1006
180,000	200,000	1295	1385	1443	1486	1521	1569	977	1037	1075	1103	1126	1156	961	1000	1025	1043	1058	1078	1238	1313	1361	1398	1428	1468	971	1008	1031	1049	1063	1083
200,000	or more	1824	1935	2005	2059	2102	2161	1351	1427	1475	1511	1539	1578	1378	1425	1454	1476	1494	1518	1769	1856	1912	1955	1990	2038	1384	1425	1451	1471	1487	1509
Income		**Michigan**					**6.0000%**	**Minnesota**[1]					**6.6890%**	**Mississippi**					**7.0000%**	**Missouri**					**4.2250%**	**Nebraska**					**5.5000%**
$0	$20,000	215	236	249	258	266	277	224	239	248	255	261	268	393	451	489	519	543	576	161	181	194	204	212	223	233	252	263	272	279	289
20,000	30,000	351	382	402	417	429	446	387	411	427	438	447	459	628	717	776	821	858	909	265	296	316	331	343	360	395	426	446	460	471	487
30,000	40,000	424	461	485	502	516	535	476	505	524	537	548	562	750	855	924	976	1020	1079	320	357	380	398	413	432	483	520	543	560	574	593
40,000	50,000	490	532	558	578	593	615	555	589	610	625	638	654	857	975	1052	1111	1160	1227	370	411	438	458	474	496	560	603	629	649	665	686
50,000	60,000	552	597	626	647	665	688	628	666	689	707	720	739	954	1083	1168	1233	1286	1360	417	462	491	513	531	555	632	679	708	730	748	772
60,000	70,000	610	659	690	713	732	757	696	738	764	783	798	818	1043	1183	1274	1345	1402	1482	461	509	541	564	584	610	698	750	782	806	825	851
70,000	80,000	667	719	752	776	796	823	762	807	835	856	872	894	1128	1278	1376	1451	1512	1598	503	555	589	614	635	663	761	817	852	878	899	927
80,000	90,000	721	776	811	837	858	886	825	873	903	925	942	966	1208	1366	1470	1550	1615	1705	544	599	634	661	683	713	821	881	918	946	968	998
90,000	100,000	774	831	868	895	918	948	885	936	968	991	1010	1035	1284	1451	1561	1644	1713	1808	584	641	679	707	730	762	879	942	982	1011	1035	1067
100,000	120,000	846	907	946	975	998	1030	966	1021	1056	1081	1101	1128	1385	1563	1680	1770	1843	1944	638	699	739	769	793	827	956	1024	1067	1099	1124	1158
120,000	140,000	948	1014	1056	1087	1113	1147	1080	1141	1179	1206	1228	1258	1526	1719	1846	1943	2022	2132	714	781	824	856	883	919	1064	1139	1186	1220	1248	1286
140,000	160,000	1042	1112	1156	1190	1217	1253	1182	1248	1289	1319	1342	1374	1651	1857	1993	2096	2181	2298	784	855	901	935	964	1002	1160	1241	1291	1329	1359	1399
160,000	180,000	1139	1213	1260	1295	1324	1362	1286	1357	1401	1433	1458	1493	1777	1996	2140	2250	2340	2465	856	931	980	1017	1047	1088	1257	1344	1398	1438	1471	1514
180,000	200,000	1230	1308	1357	1394	1424	1464	1382	1457	1504	1538	1565	1602	1892	2123	2274	2390	2485	2616	924	1003	1054	1092	1124	1167	1347	1439	1496	1539	1573	1619
200,000	or more	1734	1827	1887	1932	1968	2017	1887	1985	2046	2090	2126	2173	2483	2772	2961	3105	3223	3387	1296	1393	1455	1503	1542	1595	1812	1931	2005	2060	2104	2163

(Continued on next page)

2009 Optional State and Certain Local Sales Tax Tables *(Continued)*

Income		Exemptions						Exemptions						Exemptions						Exemptions						Exemptions					
At least	But less than	1	2	3	4	5	Over 5	1	2	3	4	5	Over 5	1	2	3	4	5	Over 5	1	2	3	4	5	Over 5	1	2	3	4	5	Over 5
		Nevada[1, 3] 6.6764%						**New Jersey[4] 7.0000%**						**New Mexico 5.0000%**						**New York 4.0000%**						**North Carolina[1] 4.8973%**					
$0	$20,000	239	262	276	287	296	307	244	260	271	278	284	292	218	236	248	256	263	273	145	154	159	163	166	171	206	225	237	246	253	263
20,000	30,000	389	423	445	462	475	493	418	444	460	472	481	494	372	402	421	435	446	461	247	261	270	276	281	288	340	371	390	404	415	430
30,000	40,000	470	510	536	555	571	592	514	544	563	577	588	603	455	491	513	530	543	561	303	320	330	338	344	352	412	448	471	487	501	519
40,000	50,000	543	588	617	638	656	679	600	634	656	671	684	701	528	569	595	614	629	650	353	372	384	393	399	409	476	516	542	561	576	597
50,000	60,000	611	660	692	715	734	760	679	717	741	759	773	791	595	641	670	691	708	731	399	421	434	443	451	461	534	579	607	628	645	668
60,000	70,000	675	728	762	787	808	836	754	796	821	840	856	876	658	708	739	763	781	807	443	466	480	491	499	510	589	637	668	691	709	734
70,000	80,000	737	794	830	857	879	909	827	872	899	919	936	958	718	772	806	831	851	879	486	510	526	537	546	558	641	693	726	751	770	797
80,000	90,000	797	857	895	924	947	978	897	944	973	994	1012	1035	774	832	869	896	917	947	526	552	568	580	590	603	690	746	781	807	828	856
90,000	100,000	855	918	958	988	1013	1045	964	1013	1044	1067	1085	1110	828	890	929	958	981	1012	565	593	610	622	632	646	738	796	833	861	883	913
100,000	120,000	934	1001	1044	1076	1101	1136	1055	1107	1140	1165	1184	1211	901	968	1009	1040	1065	1099	618	647	666	679	690	704	801	864	904	933	957	989
120,000	140,000	1048	1120	1166	1200	1227	1265	1183	1241	1276	1303	1324	1353	1003	1076	1122	1156	1183	1220	693	725	745	759	771	787	890	959	1002	1035	1061	1096
140,000	160,000	1151	1227	1276	1312	1342	1382	1300	1361	1399	1427	1450	1481	1093	1172	1222	1258	1288	1327	760	794	816	831	844	861	970	1044	1090	1125	1153	1190
160,000	180,000	1258	1339	1390	1429	1460	1502	1419	1484	1525	1555	1579	1611	1185	1270	1323	1362	1394	1436	829	866	888	905	918	936	1051	1130	1179	1216	1246	1286
180,000	200,000	1359	1443	1497	1537	1570	1614	1530	1598	1641	1673	1698	1732	1270	1360	1416	1458	1491	1536	894	932	956	973	987	1006	1125	1209	1261	1300	1332	1374
200,000	or more	1915	2017	2082	2131	2170	2224	2125	2210	2263	2302	2333	2376	1708	1824	1897	1951	1994	2052	1238	1286	1315	1337	1355	1378	1517	1623	1690	1739	1779	1833
Income		**North Dakota 5.0000%**						**Ohio 5.5000%**						**Oklahoma 4.5000%**						**Pennsylvania 6.0000%**						**Rhode Island 7.0000%**					
$0	$20,000	168	191	206	217	226	239	225	242	253	261	268	277	223	259	282	300	315	336	203	218	227	234	239	246	239	258	269	278	285	294
20,000	30,000	276	311	334	351	365	385	376	404	422	434	445	459	356	411	447	474	497	529	340	362	376	386	395	406	387	415	433	446	457	471
30,000	40,000	335	376	403	423	440	463	459	491	512	527	539	556	427	491	533	565	592	628	414	440	457	469	479	492	466	499	520	536	548	564
40,000	50,000	389	434	464	487	506	531	532	569	592	610	623	642	490	561	608	644	674	715	481	510	529	542	553	568	535	573	596	614	628	646
50,000	60,000	439	489	521	546	567	595	600	641	667	686	701	721	548	626	677	717	749	795	543	575	595	610	622	639	599	641	666	685	701	721
60,000	70,000	486	540	575	602	624	654	664	708	736	757	773	795	602	686	741	784	819	868	601	636	658	674	687	704	659	704	731	752	768	791
70,000	80,000	533	590	628	656	680	712	725	773	803	825	843	867	655	744	803	849	886	938	657	695	718	735	749	768	716	764	794	816	834	857
80,000	90,000	577	638	677	708	732	767	784	834	866	890	909	934	705	799	862	910	950	1005	711	751	775	794	808	828	770	821	853	876	895	920
90,000	100,000	621	684	726	758	784	820	840	894	927	952	972	999	754	853	918	969	1010	1068	763	805	831	850	865	886	823	876	909	934	954	980
100,000	120,000	681	748	792	826	853	892	916	974	1010	1036	1058	1086	820	924	994	1048	1092	1154	834	878	905	926	942	964	893	950	985	1011	1032	1061
120,000	140,000	767	839	887	923	953	994	1024	1087	1126	1155	1178	1209	913	1026	1102	1160	1207	1274	934	981	1011	1033	1051	1075	991	1053	1091	1120	1143	1173
140,000	160,000	846	923	973	1011	1043	1086	1121	1188	1230	1261	1286	1319	999	1119	1199	1260	1311	1382	1024	1075	1106	1130	1149	1174	1079	1145	1186	1217	1241	1274
160,000	180,000	929	1010	1062	1103	1136	1182	1221	1292	1337	1370	1396	1432	1087	1214	1298	1363	1417	1492	1117	1171	1204	1229	1249	1276	1168	1239	1283	1315	1341	1376
180,000	200,000	1008	1091	1146	1189	1224	1272	1313	1389	1435	1470	1498	1536	1170	1303	1391	1459	1515	1594	1203	1259	1295	1321	1342	1370	1251	1325	1372	1406	1433	1470
200,000	or more	1448	1547	1613	1664	1705	1763	1808	1902	1961	2004	2039	2087	1627	1786	1893	1976	2044	2140	1668	1736	1779	1811	1837	1871	1686	1780	1838	1881	1915	1961
Income		**South Carolina 6.0000%**						**South Dakota 4.0000%**						**Tennessee 7.0000%**						**Texas 6.2500%**						**Utah 4.7000%**					
$0	$20,000	244	263	274	283	290	299	227	261	283	300	314	333	341	393	427	454	475	505	259	284	300	312	322	335	226	256	276	291	303	319
20,000	30,000	408	438	457	470	481	496	363	415	449	475	496	526	541	619	671	711	743	789	438	479	505	525	541	562	369	416	446	469	488	514
30,000	40,000	497	532	554	570	583	601	433	494	534	565	590	624	646	737	798	844	882	934	534	584	615	638	657	683	446	500	536	563	585	616
40,000	50,000	575	615	640	658	673	693	495	563	608	642	671	710	739	841	909	960	1002	1061	620	676	712	738	760	789	513	575	615	645	670	705
50,000	60,000	647	691	719	739	756	778	551	626	675	713	744	786	825	936	1010	1066	1112	1177	698	761	800	830	854	886	575	643	687	721	748	786
60,000	70,000	713	762	792	814	832	856	602	683	737	777	811	857	905	1024	1103	1164	1214	1283	771	839	882	915	941	976	633	707	754	791	820	861
70,000	80,000	778	830	863	887	906	932	651	738	795	839	874	924	981	1109	1193	1258	1311	1384	841	915	961	996	1024	1063	689	768	819	858	889	933
80,000	90,000	839	895	929	955	975	1003	697	789	850	896	934	986	1054	1188	1277	1346	1402	1480	907	985	1035	1073	1103	1144	742	825	880	921	954	1001
90,000	100,000	897	956	993	1020	1042	1071	741	838	902	950	990	1046	1124	1265	1358	1430	1489	1571	970	1054	1107	1146	1178	1221	793	881	938	982	1017	1066
100,000	120,000	976	1039	1079	1108	1131	1162	800	903	971	1023	1065	1124	1218	1368	1467	1543	1606	1692	1055	1145	1202	1244	1278	1325	862	955	1016	1063	1100	1153
120,000	140,000	1086	1155	1199	1231	1256	1290	881	993	1067	1123	1169	1233	1350	1512	1619	1701	1768	1862	1173	1272	1334	1381	1418	1469	958	1060	1126	1176	1217	1274
140,000	160,000	1185	1259	1306	1340	1367	1404	953	1072	1151	1211	1260	1329	1469	1641	1755	1842	1914	2013	1279	1385	1452	1502	1543	1598	1045	1153	1224	1278	1322	1382
160,000	180,000	1285	1365	1415	1451	1481	1520	1025	1153	1236	1300	1352	1425	1590	1772	1893	1985	2061	2167	1386	1500	1572	1626	1669	1728	1133	1249	1324	1381	1428	1492
180,000	200,000	1378	1462	1515	1554	1585	1626	1092	1226	1313	1381	1436	1512	1703	1894	2020	2117	2197	2307	1485	1605	1681	1738	1784	1847	1215	1337	1416	1476	1525	1593
200,000	or more	1863	1972	2039	2089	2128	2182	1432	1600	1709	1793	1862	1957	2302	2536	2691	2810	2908	3043	1997	2151	2250	2323	2382	2462	1651	1802	1901	1976	2037	2122
Income		**Vermont 6.0000%**						**Virginia 4.0000%**						**Washington 6.5000%**						**West Virginia 6.0000%**						**Wisconsin 5.0000%**					
$0	$20,000	140	147	151	154	156	159	161	182	196	207	215	227	259	282	297	308	317	329	283	318	342	359	373	393	209	227	238	246	253	262
20,000	30,000	241	251	257	262	266	271	256	288	309	325	338	355	440	478	502	520	534	554	465	520	556	583	606	636	356	385	403	416	427	441
30,000	40,000	296	308	316	322	326	332	307	344	369	387	402	422	539	585	613	634	651	674	562	627	670	702	728	764	435	469	491	507	520	537
40,000	50,000	346	360	369	375	380	386	353	394	421	442	458	481	628	679	712	736	755	782	648	722	770	806	835	876	505	544	569	587	602	622
50,000	60,000	392	408	417	424	430	437	395	440	469	492	510	535	710	767	803	830	851	880	727	809	861	901	934	978	569	613	641	661	677	699
60,000	70,000	436	453	463	471	477	485	434	483	515	539	558	585	788	849	888	917	941	973	801	890	947	990	1025	1073	629	677	707	729	747	771
70,000	80,000	478	497	508	516	523	531	473	525	558	584	605	633	862	929	971	1002	1027	1062	873	967	1028	1075	1112	1164	686	738	771	795	814	840
80,000	90,000	518	538	550	559	566	575	510	564	600	627	649	679	933	1004	1049	1082	1109	1146	941	1041	1106	1155	1195	1250	741	796	831	856	877	905
90,000	100,000	557	578	591	600	608	618	545	602	640	668	691	723	1002	1077	1125	1160	1188	1227	1006	1111	1180	1232	1274	1332	793	851	888	916	937	967
100,000	120,000	610	632	646	656	664	675	594	654	694	724	748	782	1095	1175	1226	1264	1294	1336	1094	1206	1279	1335	1380	1442	862	925	965	995	1018	1050
120,000	140,000	684	709	724	735	744	756	663	728	770	803	829	865	1226	1314	1369	1411	1444	1489	1217	1340	1419	1479	1528	1596	959	1029	1073	1105	1131	1166
140,000	160,000	751	778	795	807	816	829	726	795	840	874	902	940	1344	1439	1498	1543	1578	1627	1328	1459	1544	1608	1661	1733	1046	1121	1168	1203	1231	1269
160,000	180,000	820	849	867	880	890	903	791	864	911	947	977	1018	1466	1566	1630	1678	1716	1768	1442	1581	1672	1740	1796	1872	1134	1215	1265	1303	1332	1373
180,000	200,000	884	915	934	947	958	972	852	928	978	1016	1047	1089	1578	1685	1752	1802	1842	1897	1547	1694	1789	1861	1920	2000	1215	1300	1354	1394	1425	1468
200,000	or more	1225	1265	1289	1307	1321	1339	1188	1280	1340	1386	1423	1475	2180	2315	2400	2464	2515	2584	2106	2289	2408	2498	2571	2672	1635	1746	1815	1866	1907	1962
Income		**Wyoming 4.0000%**																													
$0	$20,000	154	167	175	181	186	193																								
20,000	30,000	264	285	298	308	316	327																								
30,000	40,000	324	349	365	377	386	399																								
40,000	50,000	378	407	425	438	449	463																								
50,000	60,000	428	460	480	495	506	523																								
60,000	70,000	475	510	532	548	561	578																								
70,000	80,000	521	558	581	599	613	632																								
80,000	90,000	564	604	629	647	662	682																								
90,000	100,000	606	648	675	694	710	731																								
100,000	120,000	663	708	736	757	774	797																								
120,000	140,000	743	792	823	846	865	890																								
140,000	160,000	816	869	902	926	946	973																								
160,000	180,000	890	946	982	1008	1030	1058																								
180,000	200,000	959	1019	1056	1084	1107	1137																								
200,000	or more	1328	1404	1452	1487	1516	1554																								

Note. Alaska does not have a state sales tax. Alaska residents should follow the instructions on the next page to determine their local sales tax amount.

1 The rates for California, the District of Columbia, Massachusetts, Minnesota, Nevada, and North Carolina increased during 2009, so the rates given are averaged over the year.

2 The California table includes the 1% uniform local sales tax rate in addition to the 7.0034% state sales tax rate.

3 The Nevada table includes the 2.25% uniform local sales tax rate in addition to the 4.4264% state sales tax rate.

4 Residents of Salem County should deduct only half of the amount in the state table.

Which Optional Local Sales Tax Table Should I Use?

IF you live in the state of...	AND you live in...	THEN use Local Table...
Alaska	Any locality	C
Arizona	Mesa, Phoenix, or Tucson	A
	Chandler, Gilbert, Glendale, Peoria, Scottsdale, Tempe, Yuma, or any other locality	B
Arkansas	Any locality	C
California	Los Angeles County	A
Colorado	Arvada, Aurora, City of Boulder, Fort Collins, Greeley, Longmont, Thornton, or Westminster	B
	Adams County, Arapahoe County, Boulder County, Centennial, Colorado Springs, Denver City/Denver County, El Paso County, Jefferson County, Lakewood, Larimer County, City of Pueblo, Pueblo County, or any other locality	A
Georgia	Any locality	B
Illinois	Any locality	A
Louisiana	Any locality	C
Missouri	Any locality	C
New York	New York City, or one of the following counties: Albany, Allegany, Cattaraugus, Cayuga, Chemung, Clinton, Cortland, Erie, Essex, Franklin, Fulton, Genesee, Herkimer, Jefferson, Lewis, Livingston, Monroe, Montgomery, Nassau, Niagara, Oneida, Onondaga, Ontario, Orange, Orleans, Oswego, Otsego, Putnam, Rensselaer, Rockland, St. Lawrence, Saratoga, Schenectady, Schoharie, Seneca, Steuben, Suffolk, Sullivan, Tompkins, Ulster, Warren, Washington, Westchester, Wyoming, or Yates	A
	Any other locality	D
North Carolina	Any locality	A
South Carolina	Cherokee, Chesterfield, Darlington, Dillon, Horry, Jasper, Lee, Lexington, or Myrtle Beach	B
	Any other locality	C
Tennessee	Any locality	C
Utah	Any locality	B
Virginia	Any locality	B

2009 Optional Local Sales Tax Tables for Certain Local Jurisdictions

(Based on a local sales tax rate of 1 percent)

Income		Local Table A						Local Table B						Local Table C						Local Table D					
		Exemptions						Exemptions						Exemptions						Exemptions					
At least	But less than	1	2	3	4	5	Over 5	1	2	3	4	5	Over 5	1	2	3	4	5	Over 5	1	2	3	4	5	Over 5
$0	$20,000	37	41	44	46	47	49	45	51	55	59	61	65	56	64	69	73	76	81	36	39	40	41	42	43
20,000	30,000	61	67	71	74	76	79	72	82	88	93	96	102	89	101	109	115	120	126	62	65	68	69	70	72
30,000	40,000	74	81	85	89	91	95	86	98	105	110	115	121	106	120	129	136	142	150	76	80	83	85	86	88
40,000	50,000	85	93	98	102	105	109	99	112	120	126	131	138	121	137	147	155	162	170	88	93	96	98	100	102
50,000	60,000	96	105	110	114	117	122	111	124	133	140	146	153	135	152	164	172	179	189	100	105	109	111	113	115
60,000	70,000	106	115	121	126	129	134	122	136	146	153	159	168	148	167	179	188	196	206	111	117	120	123	125	128
70,000	80,000	116	126	132	137	141	146	132	148	158	166	172	181	160	180	193	203	211	222	122	128	132	134	137	140
80,000	90,000	125	136	142	147	151	157	142	159	170	178	185	194	172	193	207	217	226	237	132	138	142	145	148	151
90,000	100,000	134	145	152	157	162	167	152	170	181	190	197	207	183	205	219	230	239	252	141	148	153	156	158	162
100,000	120,000	147	158	166	171	176	182	165	184	196	205	213	223	198	221	237	248	258	271	155	162	167	170	173	176
120,000	140,000	164	177	185	191	196	202	184	204	217	227	235	246	219	244	261	273	284	298	173	181	186	190	193	197
140,000	160,000	180	194	202	209	214	221	201	222	236	247	255	267	237	264	282	296	307	322	190	199	204	208	211	215
160,000	180,000	197	211	220	227	232	240	218	241	256	267	276	289	256	285	304	318	330	346	207	217	222	226	230	234
180,000	200,000	213	227	237	244	249	257	235	258	274	285	295	308	274	304	323	339	351	368	224	233	239	243	247	252
200,000 or more		298	316	327	336	343	352	323	351	370	385	397	413	365	402	427	445	461	482	310	322	329	334	339	345

Appendix B

TAX FORMS

(Tax forms can be obtained from the IRS web site: **www.irs.gov**)

Form 1040	U.S. Individual Income Tax Return	B-2
Schedule C	Profit or Loss from Business	B-4
Schedule D	Capital Gains and Losses	B-6
Form 1065	U.S. Return of Partnership Income	B-8
Schedule K-1	Partner's Share of Income, Deductions, Credits, etc.	B-13
Form 1120	U.S. Corporation Income Tax Return	B-14
Schedule M–3	Net Income (Loss) Reconciliation for Corporations with Total Assets of $10 Million or More	B-19
Form 1120S	U.S. Income Tax Return for an S Corporation	B-22
Schedule K-1	Shareholder's Share of Income, Deductions, Credits, etc.	B-26
Form 2553	Election by a Small Business Corporation	B-27
Form 4562	Depreciation and Amortization	B-29
Form 4626	Alternative Minimum Tax—Corporations	B-31
Form 4797	Sales of Business Property	B-32
Form 6251	Alternative Minimum Tax—Individuals	B-34

Form **1040** Department of the Treasury—Internal Revenue Service **U.S. Individual Income Tax Return** **2009** (99) IRS Use Only—Do not write or staple in this space.

Label (See instructions on page 14.) **Use the IRS label.** Otherwise, please print or type. **Presidential Election Campaign**

LABEL HERE

For the year Jan. 1–Dec. 31, 2009, or other tax year beginning , 2009, ending , 20 — OMB No. 1545-0074

Your first name and initial	Last name	**Your social security number**
If a joint return, spouse's first name and initial	Last name	**Spouse's social security number**
Home address (number and street). If you have a P.O. box, see page 14.	Apt. no.	▲ You **must** enter your SSN(s) above. ▲
City, town or post office, state, and ZIP code. If you have a foreign address, see page 14.		Checking a box below will not change your tax or refund.

▶ Check here if you, or your spouse if filing jointly, want $3 to go to this fund (see page 14) ▶ ☐ You ☐ Spouse

Filing Status Check only one box.

1 ☐ Single
2 ☐ Married filing jointly (even if only one had income)
3 ☐ Married filing separately. Enter spouse's SSN above and full name here. ▶
4 ☐ Head of household (with qualifying person). (See page 15.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶
5 ☐ Qualifying widow(er) with dependent child (see page 16)

Exemptions

6a ☐ **Yourself.** If someone can claim you as a dependent, **do not** check box 6a
b ☐ **Spouse**

c **Dependents:**

(1) First name Last name	(2) Dependent's social security number	(3) Dependent's relationship to you	(4) ✓ if qualifying child for child tax credit (see page 17)
			☐
			☐
			☐
			☐

If more than four dependents, see page 17 and check here ▶ ☐

d Total number of exemptions claimed

Boxes checked on 6a and 6b ____
No. of children on 6c who:
• **lived with you** ____
• **did not live with you due to divorce or separation (see page 18)** ____
Dependents on 6c not entered above ____
Add numbers on lines above ▶ ☐

Income

Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld.

If you did not get a W-2, see page 22.

Enclose, but do not attach, any payment. Also, please use **Form 1040-V.**

7	Wages, salaries, tips, etc. Attach Form(s) W-2		7
8a	**Taxable** interest. Attach Schedule B if required		8a
b	**Tax-exempt** interest. **Do not** include on line 8a	8b	
9a	Ordinary dividends. Attach Schedule B if required		9a
b	Qualified dividends (see page 22)	9b	
10	Taxable refunds, credits, or offsets of state and local income taxes (see page 23)		10
11	Alimony received		11
12	Business income or (loss). Attach Schedule C or C-EZ		12
13	Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ ☐		13
14	Other gains or (losses). Attach Form 4797		14
15a	IRA distributions 15a	b Taxable amount (see page 24)	15b
16a	Pensions and annuities 16a	b Taxable amount (see page 25)	16b
17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E		17
18	Farm income or (loss). Attach Schedule F		18
19	Unemployment compensation in excess of $2,400 per recipient (see page 27)		19
20a	Social security benefits 20a	b Taxable amount (see page 27)	20b
21	Other income. List type and amount (see page 29)		21
22	Add the amounts in the far right column for lines 7 through 21. This is your **total income** ▶		22

Adjusted Gross Income

23	Educator expenses (see page 29)	23	
24	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ	24	
25	Health savings account deduction. Attach Form 8889	25	
26	Moving expenses. Attach Form 3903	26	
27	One-half of self-employment tax. Attach Schedule SE	27	
28	Self-employed SEP, SIMPLE, and qualified plans	28	
29	Self-employed health insurance deduction (see page 30)	29	
30	Penalty on early withdrawal of savings	30	
31a	Alimony paid b Recipient's SSN ▶	31a	
32	IRA deduction (see page 31)	32	
33	Student loan interest deduction (see page 34)	33	
34	Tuition and fees deduction. Attach Form 8917	34	
35	Domestic production activities deduction. Attach Form 8903	35	
36	Add lines 23 through 31a and 32 through 35		36
37	Subtract line 36 from line 22. This is your **adjusted gross income** ▶		37

Form 1040 (2009) Page 2

Tax and Credits

38	Amount from line 37 (adjusted gross income)			38
39a	Check if: ☐ **You** were born before January 2, 1945, ☐ Blind. ☐ **Spouse** was born before January 2, 1945, ☐ Blind. **Total boxes checked ▶ 39a**			
b	If your spouse itemizes on a separate return or you were a dual-status alien, see page 35 and check here ▶ **39b** ☐			
40a	**Itemized deductions** (from Schedule A) **or** your **standard deduction** (see left margin)			40a
b	If you are increasing your standard deduction by certain real estate taxes, new motor vehicle taxes, or a net disaster loss, attach Schedule L and check here (see page 35) ▶ **40b** ☐			
41	Subtract line 40a from line 38			41
42	**Exemptions.** If line 38 is $125,100 or less and you did not provide housing to a Midwestern displaced individual, multiply $3,650 by the number on line 6d. Otherwise, see page 37			42
43	**Taxable income.** Subtract line 42 from line 41. If line 42 is more than line 41, enter -0-			43
44	**Tax** (see page 37). Check if any tax is from: **a** ☐ Form(s) 8814 **b** ☐ Form 4972			44
45	**Alternative minimum tax** (see page 40). Attach Form 6251			45
46	Add lines 44 and 45 ▶			46
47	Foreign tax credit. Attach Form 1116 if required	47		
48	Credit for child and dependent care expenses. Attach Form 2441	48		
49	Education credits from Form 8863, line 29	49		
50	Retirement savings contributions credit. Attach Form 8880	50		
51	Child tax credit (see page 42)	51		
52	Credits from Form: **a** ☐ 8396 **b** ☐ 8839 **c** ☐ 5695	52		
53	Other credits from Form: **a** ☐ 3800 **b** ☐ 8801 **c** ☐	53		
54	Add lines 47 through 53. These are your **total credits**			54
55	Subtract line 54 from line 46. If line 54 is more than line 46, enter -0- ▶			55

Standard Deduction for—

- People who check any box on line 39a, 39b, or 40b **or** who can be claimed as a dependent, see page 35.
- All others:

Single or Married filing separately, $5,700

Married filing jointly or Qualifying widow(er), $11,400

Head of household, $8,350

Other Taxes

56	Self-employment tax. Attach Schedule SE	56
57	Unreported social security and Medicare tax from Form: **a** ☐ 4137 **b** ☐ 8919	57
58	Additional tax on IRAs, other qualified retirement plans, etc. Attach Form 5329 if required	58
59	Additional taxes: **a** ☐ AEIC payments **b** ☐ Household employment taxes. Attach Schedule H	59
60	Add lines 55 through 59. This is your **total tax** ▶	60

Payments

61	Federal income tax withheld from Forms W-2 and 1099	61		
62	2009 estimated tax payments and amount applied from 2008 return	62		
63	Making work pay and government retiree credits. Attach Schedule M	63		
64a	**Earned income credit (EIC)**	64a		
b	Nontaxable combat pay election **64b**			
65	Additional child tax credit. Attach Form 8812	65		
66	Refundable education credit from Form 8863, line 16	66		
67	First-time homebuyer credit. Attach Form 5405	67		
68	Amount paid with request for extension to file (see page 72)	68		
69	Excess social security and tier 1 RRTA tax withheld (see page 72)	69		
70	Credits from Form: **a** ☐ 2439 **b** ☐ 4136 **c** ☐ 8801 **d** ☐ 8885	70		
71	Add lines 61, 62, 63, 64a, and 65 through 70. These are your **total payments** ▶			71

If you have a qualifying child, attach Schedule EIC.

Refund

Direct deposit? See page 73 and fill in 73b, 73c, and 73d, or Form 8888.

72	If line 71 is more than line 60, subtract line 60 from line 71. This is the amount you **overpaid**		72
73a	Amount of line 72 you want **refunded to you.** If Form 8888 is attached, check here ▶ ☐		73a
▶ b	Routing number ▶ **c** Type: ☐ Checking ☐ Savings		
▶ d	Account number		
74	Amount of line 72 you want **applied to your 2010 estimated tax** ▶	74	

Amount You Owe

75	**Amount you owe.** Subtract line 71 from line 60. For details on how to pay, see page 74 ▶		75
76	Estimated tax penalty (see page 74)	76	

Third Party Designee

Do you want to allow another person to discuss this return with the IRS (see page 75)? ☐ **Yes.** Complete the following. ☐ **No**

Designee's name ▶ | Phone no. ▶ | Personal identification number (PIN) ▶

Sign Here

Joint return? See page 15. Keep a copy for your records.

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Your signature	Date	Your occupation	Daytime phone number
Spouse's signature. If a joint return, **both** must sign.	Date	Spouse's occupation	

Paid Preparer's Use Only

Preparer's signature		Date	Check if self-employed ☐	Preparer's SSN or PTIN
Firm's name (or yours if self-employed), address, and ZIP code			EIN / Phone no.

Form **1040** (2009)

SCHEDULE C (Form 1040)

Department of the Treasury
Internal Revenue Service (99)

Profit or Loss From Business

(Sole Proprietorship)

▶ Partnerships, joint ventures, etc., generally must file Form 1065 or 1065-B.
▶ Attach to Form 1040, 1040NR, or 1041. ▶ See Instructions for Schedule C (Form 1040).

OMB No. 1545-0074

2009

Attachment Sequence No. **09**

Name of proprietor | Social security number (SSN)

A Principal business or profession, including product or service (see page C-2 of the instructions) | B Enter code from pages C-9, 10, & 11 ▶

C Business name. If no separate business name, leave blank. | D Employer ID number (EIN), if any

E Business address (including suite or room no.) ▶
City, town or post office, state, and ZIP code

F Accounting method: (1) ☐ Cash (2) ☐ Accrual (3) ☐ Other (specify) ▶

G Did you "materially participate" in the operation of this business during 2009? If "No," see page C-3 for limit on losses ☐ Yes ☐ No

H If you started or acquired this business during 2009, check here ▶ ☐

Part I Income

1	Gross receipts or sales. **Caution.** See page C-4 and check the box if: • This income was reported to you on Form W-2 and the "Statutory employee" box on that form was checked, or • You are a member of a qualified joint venture reporting only rental real estate income not subject to self-employment tax. Also see page C-3 for limit on losses. ▶ ☐	1	
2	Returns and allowances	2	
3	Subtract line 2 from line 1	3	
4	Cost of goods sold (from line 42 on page 2)	4	
5	**Gross profit.** Subtract line 4 from line 3	5	
6	Other income, including federal and state gasoline or fuel tax credit or refund (see page C-4)	6	
7	**Gross income.** Add lines 5 and 6 ▶	7	

Part II Expenses. Enter expenses for business use of your home **only** on line 30.

8	Advertising	8		18	Office expense	18	
9	Car and truck expenses (see page C-4)	9		19	Pension and profit-sharing plans	19	
10	Commissions and fees	10		20	Rent or lease (see page C-6):		
11	Contract labor (see page C-4)	11		a	Vehicles, machinery, and equipment	20a	
12	Depletion	12		b	Other business property	20b	
13	Depreciation and section 179 expense deduction (not included in Part III) (see page C-5)	13		21	Repairs and maintenance	21	
				22	Supplies (not included in Part III)	22	
				23	Taxes and licenses	23	
				24	Travel, meals, and entertainment:		
				a	Travel	24a	
14	Employee benefit programs (other than on line 19)	14		b	Deductible meals and entertainment (see page C-6)	24b	
15	Insurance (other than health)	15		25	Utilities	25	
16	Interest:			26	Wages (less employment credits)	26	
a	Mortgage (paid to banks, etc.)	16a		27	Other expenses (from line 48 on page 2)	27	
b	Other	16b					
17	Legal and professional services	17					

28	**Total expenses** before expenses for business use of home. Add lines 8 through 27 ▶	28	
29	Tentative profit or (loss). Subtract line 28 from line 7	29	
30	Expenses for business use of your home. Attach **Form 8829**	30	
31	**Net profit or (loss).** Subtract line 30 from line 29. • If a profit, enter on both **Form 1040, line 12,** and **Schedule SE, line 2,** or on **Form 1040NR, line 13** (if you checked the box on line 1, see page C-7). Estates and trusts, enter on **Form 1041, line 3.** • If a loss, you **must** go to line 32.	31	
32	If you have a loss, check the box that describes your investment in this activity (see page C-7). • If you checked 32a, enter the loss on both **Form 1040, line 12,** and **Schedule SE, line 2,** or on **Form 1040NR, line 13** (if you checked the box on line 1, see the line 31 instructions on page C-7). Estates and trusts, enter on **Form 1041, line 3.** • If you checked 32b, you **must** attach **Form 6198.** Your loss may be limited.	32a ☐ All investment is at risk. 32b ☐ Some investment is not at risk.	

Schedule C (Form 1040) 2009 Page 2

Part III Cost of Goods Sold (see page C-8)

33 Method(s) used to value closing inventory: a ☐ Cost b ☐ Lower of cost or market c ☐ Other (attach explanation)

34 Was there any change in determining quantities, costs, or valuations between opening and closing inventory? If "Yes," attach explanation . . . ☐ Yes ☐ No

35	Inventory at beginning of year. If different from last year's closing inventory, attach explanation	35	
36	Purchases less cost of items withdrawn for personal use	36	
37	Cost of labor. Do not include any amounts paid to yourself	37	
38	Materials and supplies	38	
39	Other costs	39	
40	Add lines 35 through 39	40	
41	Inventory at end of year	41	
42	**Cost of goods sold.** Subtract line 41 from line 40. Enter the result here and on page 1, line 4	42	

Part IV Information on Your Vehicle. Complete this part **only** if you are claiming car or truck expenses on line 9 and are not required to file Form 4562 for this business. See the instructions for line 13 on page C-5 to find out if you must file Form 4562.

43 When did you place your vehicle in service for business purposes? (month, day, year) ▶ / /

44 Of the total number of miles you drove your vehicle during 2009, enter the number of miles you used your vehicle for:

a Business _____ b Commuting (see instructions) _____ c Other _____

45 Was your vehicle available for personal use during off-duty hours? . . . ☐ Yes ☐ No

46 Do you (or your spouse) have another vehicle available for personal use? . . . ☐ Yes ☐ No

47a Do you have evidence to support your deduction? . . . ☐ Yes ☐ No

b If "Yes," is the evidence written? . . . ☐ Yes ☐ No

Part V Other Expenses. List below business expenses not included on lines 8–26 or line 30.

48 **Total other expenses.** Enter here and on page 1, line 27	48	

SCHEDULE D (Form 1040)

Department of the Treasury
Internal Revenue Service (99)

Capital Gains and Losses

▶ Attach to Form 1040 or Form 1040NR. ▶ See Instructions for Schedule D (Form 1040).
▶ Use Schedule D-1 to list additional transactions for lines 1 and 8.

OMB No. 1545-0074

2009

Attachment Sequence No. **12**

Name(s) shown on return | **Your social security number**

Part I Short-Term Capital Gains and Losses—Assets Held One Year or Less

	(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-7 of the instructions)	(e) Cost or other basis (see page D-7 of the instructions)	(f) Gain or (loss) Subtract (e) from (d)
1						
2	Enter your short-term totals, if any, from Schedule D-1, line 2			2		
3	**Total short-term sales price amounts.** Add lines 1 and 2 in column (d)			3		
4	Short-term gain from Form 6252 and short-term gain or (loss) from Forms 4684, 6781, and 8824				4	
5	Net short-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1				5	
6	Short-term capital loss carryover. Enter the amount, if any, from line 10 of your **Capital Loss Carryover Worksheet** on page D-7 of the instructions				6	( )
7	**Net short-term capital gain or (loss).** Combine lines 1 through 6 in column (f)				7	

Part II Long-Term Capital Gains and Losses—Assets Held More Than One Year

	(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-7 of the instructions)	(e) Cost or other basis (see page D-7 of the instructions)	(f) Gain or (loss) Subtract (e) from (d)
8						
9	Enter your long-term totals, if any, from Schedule D-1, line 9			9		
10	**Total long-term sales price amounts.** Add lines 8 and 9 in column (d)			10		
11	Gain from Form 4797, Part I; long-term gain from Forms 2439 and 6252; and long-term gain or (loss) from Forms 4684, 6781, and 8824				11	
12	Net long-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1				12	
13	Capital gain distributions. See page D-2 of the instructions				13	
14	Long-term capital loss carryover. Enter the amount, if any, from line 15 of your **Capital Loss Carryover Worksheet** on page D-7 of the instructions				14	( )
15	**Net long-term capital gain or (loss).** Combine lines 8 through 14 in column (f). Then go to Part III on the back				15	

Part III Summary

16 Combine lines 7 and 15 and enter the result **16**

If line 16 is:

- A **gain**, enter the amount from line 16 on Form 1040, line 13, or Form 1040NR, line 14. Then go to line 17 below.
- A **loss**, skip lines 17 through 20 below. Then go to line 21. Also be sure to complete line 22.
- **Zero**, skip lines 17 through 21 below and enter -0- on Form 1040, line 13, or Form 1040NR, line 14. Then go to line 22.

17 Are lines 15 and 16 **both** gains?

☐ **Yes.** Go to line 18.

☐ **No.** Skip lines 18 through 21, and go to line 22.

18 Enter the amount, if any, from line 7 of the **28% Rate Gain Worksheet** on page D-8 of the instructions . . . . . ▶ **18**

19 Enter the amount, if any, from line 18 of the **Unrecaptured Section 1250 Gain Worksheet** on page D-9 of the instructions . . . . . ▶ **19**

20 Are lines 18 and 19 **both** zero or blank?

☐ **Yes.** Complete Form 1040 through line 43, or Form 1040NR through line 40. Then complete the **Qualified Dividends and Capital Gain Tax Worksheet** on page 39 of the Instructions for Form 1040 (or in the Instructions for Form 1040NR). **Do not** complete lines 21 and 22 below.

☐ **No.** Complete Form 1040 through line 43, or Form 1040NR through line 40. Then complete the **Schedule D Tax Worksheet** on page D-10 of the instructions. **Do not** complete lines 21 and 22 below.

21 If line 16 is a loss, enter here and on Form 1040, line 13, or Form 1040NR, line 14, the **smaller** of:

- The loss on line 16 or
- ($3,000), or if married filing separately, ($1,500)

. . . . . **21** ( )

Note. When figuring which amount is smaller, treat both amounts as positive numbers.

22 Do you have qualified dividends on Form 1040, line 9b, or Form 1040NR, line 10b?

☐ **Yes.** Complete Form 1040 through line 43, or Form 1040NR through line 40. Then complete the **Qualified Dividends and Capital Gain Tax Worksheet** on page 39 of the Instructions for Form 1040 (or in the Instructions for Form 1040NR).

☐ **No.** Complete the rest of Form 1040 or Form 1040NR.

Form **1065**
Department of the Treasury
Internal Revenue Service

U.S. Return of Partnership Income

For calendar year 2009, or tax year beginning _____, 2009, ending _____, 20 _____.
▶ See separate instructions.

OMB No. 1545-0099
2009

A Principal business activity	Use the IRS label. Otherwise, print or type.	Name of partnership	D Employer identification number
B Principal product or service		Number, street, and room or suite no. If a P.O. box, see the instructions.	E Date business started
C Business code number		City or town, state, and ZIP code	F Total assets (see the instructions) $

G Check applicable boxes: (1) ☐ Initial return (2) ☐ Final return (3) ☐ Name change (4) ☐ Address change (5) ☐ Amended return
(6) ☐ Technical termination - also check (1) or (2)

H Check accounting method: (1) ☐ Cash (2) ☐ Accrual (3) ☐ Other (specify) ▶ _____

I Number of Schedules K-1. Attach one for each person who was a partner at any time during the tax year ▶ _____

J Check if Schedules C and M-3 are attached . . . . . ☐

Caution. *Include **only** trade or business income and expenses on lines 1a through 22 below. See the instructions for more information.*

Income	1a	Gross receipts or sales	1a			
	b	Less returns and allowances	1b		1c	
	2	Cost of goods sold (Schedule A, line 8)			2	
	3	Gross profit. Subtract line 2 from line 1c			3	
	4	Ordinary income (loss) from other partnerships, estates, and trusts *(attach statement)*			4	
	5	Net farm profit (loss) *(attach Schedule F (Form 1040))*			5	
	6	Net gain (loss) from Form 4797, Part II, line 17 *(attach Form 4797)*			6	
	7	Other income (loss) *(attach statement)*			7	
	8	**Total income (loss).** Combine lines 3 through 7			8	
Deductions (see the instructions for limitations)	9	Salaries and wages (other than to partners) (less employment credits)			9	
	10	Guaranteed payments to partners			10	
	11	Repairs and maintenance			11	
	12	Bad debts			12	
	13	Rent			13	
	14	Taxes and licenses			14	
	15	Interest			15	
	16a	Depreciation *(if required, attach Form 4562)*	16a			
	b	Less depreciation reported on Schedule A and elsewhere on return	16b		16c	
	17	Depletion **(Do not deduct oil and gas depletion.)**			17	
	18	Retirement plans, etc.			18	
	19	Employee benefit programs			19	
	20	Other deductions *(attach statement)*			20	
	21	**Total deductions.** Add the amounts shown in the far right column for lines 9 through 20			21	
	22	**Ordinary business income (loss).** Subtract line 21 from line 8			22	

Sign Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than general partner or limited liability company member manager) is based on all information of which preparer has any knowledge.

May the IRS discuss this return with the preparer shown below (see instructions)? ☐ Yes ☐ No

▶ _____ Signature of general partner or limited liability company member manager ▶ _____ Date

Paid Preparer's Use Only

Preparer's signature	Date	Check if self- employed ▶ ☐	Preparer's SSN or PTIN
Firm's name (or yours if self-employed), address, and ZIP code ▶			EIN ▶ Phone no.

Form 1065 (2009) Page 2

Schedule A Cost of Goods Sold (see the instructions)

1	Inventory at beginning of year	1	
2	Purchases less cost of items withdrawn for personal use	2	
3	Cost of labor	3	
4	Additional section 263A costs (*attach statement*)	4	
5	Other costs (*attach statement*)	5	
6	**Total.** Add lines 1 through 5	6	
7	Inventory at end of year	7	
8	**Cost of goods sold.** Subtract line 7 from line 6. Enter here and on page 1, line 2	8	

9a Check all methods used for valuing closing inventory:

(i) ☐ Cost as described in Regulations section 1.471-3

(ii) ☐ Lower of cost or market as described in Regulations section 1.471-4

(iii) ☐ Other (specify method used and attach explanation) ▶ _____

b Check this box if there was a writedown of "subnormal" goods as described in Regulations section 1.471-2(c) ▶ ☐

c Check this box if the LIFO inventory method was adopted this tax year for any goods (*if checked, attach Form 970*) ▶ ☐

d Do the rules of section 263A (for property produced or acquired for resale) apply to the partnership? ☐ Yes ☐ No

e Was there any change in determining quantities, cost, or valuations between opening and closing inventory? ☐ Yes ☐ No
If "Yes," attach explanation.

Schedule B Other Information

		Yes	No
1	What type of entity is filing this return? Check the applicable box:		
a	☐ Domestic general partnership b ☐ Domestic limited partnership		
c	☐ Domestic limited liability company d ☐ Domestic limited liability partnership		
e	☐ Foreign partnership f ☐ Other ▶ _____		
2	At any time during the tax year, was any partner in the partnership a disregarded entity, a partnership (including an entity treated as a partnership), a trust, an S corporation, an estate (other than an estate of a deceased partner), or a nominee or similar person?		
3	At the end of the tax year:		
a	Did any foreign or domestic corporation, partnership (including any entity treated as a partnership), trust, or tax-exempt organization own, directly or indirectly, an interest of 50% or more in the profit, loss, or capital of the partnership? For rules of constructive ownership, see instructions. If "Yes," attach Schedule B-1, Information on Partners Owning 50% or More of the Partnership		
b	Did any individual or estate own, directly or indirectly, an interest of 50% or more in the profit, loss, or capital of the partnership? For rules of constructive ownership, see instructions. If "Yes," attach Schedule B-1, Information on Partners Owning 50% or More of the Partnership		
4	At the end of the tax year, did the partnership:		
a	Own directly 20% or more, or own, directly or indirectly, 50% or more of the total voting power of all classes of stock entitled to vote of any foreign or domestic corporation? For rules of constructive ownership, see instructions. If "Yes," complete (i) through (iv) below		

(i) Name of Corporation	(ii) Employer Identification Number (if any)	(iii) Country of Incorporation	(iv) Percentage Owned in Voting Stock

b	Own directly an interest of 20% or more, or own, directly or indirectly, an interest of 50% or more in the profit, loss, or capital in any foreign or domestic partnership (including an entity treated as a partnership) or in the beneficial interest of a trust? For rules of constructive ownership, see instructions. If "Yes," complete (i) through (v) below				

(i) Name of Entity	(ii) Employer Identification Number (if any)	(iii) Type of Entity	(iv) Country of Organization	(v) Maximum Percentage Owned in Profit, Loss, or Capital

		Yes	No
5	Did the partnership file Form 8893, Election of Partnership Level Tax Treatment, or an election statement under section 6231(a)(1)(B)(ii) for partnership-level tax treatment, that is in effect for this tax year? See Form 8893 for more details		
6	Does the partnership satisfy **all four** of the following conditions?		
a	The partnership's total receipts for the tax year were less than $250,000.		
b	The partnership's total assets at the end of the tax year were less than $1 million.		
c	Schedules K-1 are filed with the return and furnished to the partners on or before the due date (including extensions) for the partnership return.		
d	The partnership is not filing and is not required to file Schedule M-3		
	If "Yes," the partnership is not required to complete Schedules L, M-1, and M-2; Item F on page 1 of Form 1065; or Item L on Schedule K-1.		
7	Is this partnership a publicly traded partnership as defined in section 469(k)(2)?		
8	During the tax year, did the partnership have any debt that was cancelled, was forgiven, or had the terms modified so as to reduce the principal amount of the debt?		
9	Has this partnership filed, or is it required to file, Form 8918, Material Advisor Disclosure Statement, to provide information on any reportable transaction?		
10	At any time during calendar year 2009, did the partnership have an interest in or a signature or other authority over a financial account in a foreign country (such as a bank account, securities account, or other financial account)? See the instructions for exceptions and filing requirements for Form TD F 90-22.1, Report of Foreign Bank and Financial Accounts. If "Yes," enter the name of the foreign country. ▶		
11	At any time during the tax year, did the partnership receive a distribution from, or was it the grantor of, or transferor to, a foreign trust? If "Yes," the partnership may have to file Form 3520, Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts. See instructions		
12a	Is the partnership making, or had it previously made (and not revoked), a section 754 election? See instructions for details regarding a section 754 election.		
b	Did the partnership make for this tax year an optional basis adjustment under section 743(b) or 734(b)? If "Yes," attach a statement showing the computation and allocation of the basis adjustment. See instructions		
c	Is the partnership required to adjust the basis of partnership assets under section 743(b) or 734(b) because of a substantial built-in loss (as defined under section 743(d)) or substantial basis reduction (as defined under section 734(d))? If "Yes," attach a statement showing the computation and allocation of the basis adjustment. See instructions.		
13	Check this box if, during the current or prior tax year, the partnership distributed any property received in a like-kind exchange or contributed such property to another entity (other than entities wholly-owned by the partnership throughout the tax year) ▶ ☐		
14	At any time during the tax year, did the partnership distribute to any partner a tenancy-in-common or other undivided interest in partnership property?		
15	If the partnership is required to file Form 8858, Information Return of U.S. Persons With Respect To Foreign Disregarded Entities, enter the number of Forms 8858 attached. See instructions ▶		
16	Does the partnership have any foreign partners? If "Yes," enter the number of Forms 8805, Foreign Partner's Information Statement of Section 1446 Withholding Tax, filed for this partnership. ▶		
17	Enter the number of Forms 8865, Return of U.S. Persons With Respect to Certain Foreign Partnerships, attached to this return. ▶		

Designation of Tax Matters Partner (see instructions)

Enter below the general partner designated as the tax matters partner (TMP) for the tax year of this return:

Name of designated TMP ▶		Identifying number of TMP ▶	
If the TMP is an entity, name of TMP representative ▶		Phone number of TMP ▶	
Address of designated TMP ▶			

Form 1065 (2009) Page 4

Schedule K		Partners' Distributive Share Items			Total amount
Income (Loss)	1	Ordinary business income (loss) (page 1, line 22)		1	
	2	Net rental real estate income (loss) (*attach Form 8825*)		2	
	3a	Other gross rental income (loss)	3a		
	b	Expenses from other rental activities (*attach statement*)	3b		
	c	Other net rental income (loss). Subtract line 3b from line 3a		3c	
	4	Guaranteed payments		4	
	5	Interest income		5	
	6	Dividends: a Ordinary dividends		6a	
		b Qualified dividends	6b		
	7	Royalties		7	
	8	Net short-term capital gain (loss) (*attach Schedule D (Form 1065)*)		8	
	9a	Net long-term capital gain (loss) (*attach Schedule D (Form 1065)*)		9a	
	b	Collectibles (28%) gain (loss)	9b		
	c	Unrecaptured section 1250 gain (*attach statement*)	9c		
	10	Net section 1231 gain (loss) (*attach Form 4797*)		10	
	11	Other income (loss) (*see instructions*) Type ▶		11	
Deductions	12	Section 179 deduction (*attach Form 4562*)		12	
	13a	Contributions		13a	
	b	Investment interest expense		13b	
	c	Section 59(e)(2) expenditures: (1) Type ▶ (2) Amount ▶		13c(2)	
	d	Other deductions (*see instructions*) Type ▶		13d	
Self-Employment	14a	Net earnings (loss) from self-employment		14a	
	b	Gross farming or fishing income		14b	
	c	Gross nonfarm income		14c	
Credits	15a	Low-income housing credit (section 42(j)(5))		15a	
	b	Low-income housing credit (other)		15b	
	c	Qualified rehabilitation expenditures (rental real estate) (*attach Form 3468*)		15c	
	d	Other rental real estate credits (*see instructions*) Type ▶		15d	
	e	Other rental credits (*see instructions*) Type ▶		15e	
	f	Other credits (*see instructions*) Type ▶		15f	
Foreign Transactions	16a	Name of country or U.S. possession ▶			
	b	Gross income from all sources		16b	
	c	Gross income sourced at partner level		16c	
		Foreign gross income sourced at partnership level			
	d	Passive category ▶ e General category ▶ f Other ▶		16f	
		Deductions allocated and apportioned at partner level			
	g	Interest expense ▶ h Other ▶		16h	
		Deductions allocated and apportioned at partnership level to foreign source income			
	i	Passive category ▶ j General category ▶ k Other ▶		16k	
	l	Total foreign taxes (check one): ▶ Paid ☐ Accrued ☐		16l	
	m	Reduction in taxes available for credit (*attach statement*)		16m	
	n	Other foreign tax information (*attach statement*)			
Alternative Minimum Tax (AMT) Items	17a	Post-1986 depreciation adjustment		17a	
	b	Adjusted gain or loss		17b	
	c	Depletion (other than oil and gas)		17c	
	d	Oil, gas, and geothermal properties—gross income		17d	
	e	Oil, gas, and geothermal properties—deductions		17e	
	f	Other AMT items (*attach statement*)		17f	
Other Information	18a	Tax-exempt interest income		18a	
	b	Other tax-exempt income		18b	
	c	Nondeductible expenses		18c	
	19a	Distributions of cash and marketable securities		19a	
	b	Distributions of other property		19b	
	20a	Investment income		20a	
	b	Investment expenses		20b	
	c	Other items and amounts (*attach statement*)			

Analysis of Net Income (Loss)

1	Net income (loss). Combine Schedule K, lines 1 through 11. From the result, subtract the sum of Schedule K, lines 12 through 13d, and 16l					1	
2	Analysis by partner type:	(i) Corporate	(ii) Individual (active)	(iii) Individual (passive)	(iv) Partnership	(v) Exempt organization	(vi) Nominee/Other
a	General partners						
b	Limited partners						

Schedule L Balance Sheets per Books

	Assets	Beginning of tax year (a)	Beginning of tax year (b)	End of tax year (c)	End of tax year (d)
1	Cash				
2a	Trade notes and accounts receivable				
b	Less allowance for bad debts				
3	Inventories				
4	U.S. government obligations				
5	Tax-exempt securities				
6	Other current assets (*attach statement*)				
7	Mortgage and real estate loans				
8	Other investments (*attach statement*)				
9a	Buildings and other depreciable assets				
b	Less accumulated depreciation				
10a	Depletable assets				
b	Less accumulated depletion				
11	Land (net of any amortization)				
12a	Intangible assets (amortizable only)				
b	Less accumulated amortization				
13	Other assets (*attach statement*)				
14	Total assets				
	Liabilities and Capital				
15	Accounts payable				
16	Mortgages, notes, bonds payable in less than 1 year				
17	Other current liabilities (*attach statement*)				
18	All nonrecourse loans				
19	Mortgages, notes, bonds payable in 1 year or more				
20	Other liabilities (*attach statement*)				
21	Partners' capital accounts				
22	Total liabilities and capital				

Schedule M-1 Reconciliation of Income (Loss) per Books With Income (Loss) per Return

Note. Schedule M-3 may be required instead of Schedule M-1 (see instructions).

1	Net income (loss) per books		6	Income recorded on books this year not included on Schedule K, lines 1 through 11 (itemize):	
2	Income included on Schedule K, lines 1, 2, 3c, 5, 6a, 7, 8, 9a, 10, and 11, not recorded on books this year (itemize):		a	Tax-exempt interest $	
3	Guaranteed payments (other than health insurance)		7	Deductions included on Schedule K, lines 1 through 13d, and 16l, not charged against book income this year (itemize):	
4	Expenses recorded on books this year not included on Schedule K, lines 1 through 13d, and 16l (itemize):		a	Depreciation $	
a	Depreciation $		8	Add lines 6 and 7	
b	Travel and entertainment $		9	Income (loss) (Analysis of Net Income (Loss), line 1). Subtract line 8 from line 5	
5	Add lines 1 through 4				

Schedule M-2 Analysis of Partners' Capital Accounts

1	Balance at beginning of year		6	Distributions: a Cash	
2	Capital contributed: a Cash			b Property	
	b Property		7	Other decreases (itemize):	
3	Net income (loss) per books				
4	Other increases (itemize):		8	Add lines 6 and 7	
5	Add lines 1 through 4		9	Balance at end of year. Subtract line 8 from line 5	

651109

☐ Final K-1 ☐ Amended K-1 OMB No. 1545-0099

Schedule K-1 (Form 1065)

Department of the Treasury
Internal Revenue Service

2009

For calendar year 2009, or tax year beginning _____, 2009
ending _____, 20____

Partner's Share of Income, Deductions, Credits, etc.

▶ See back of form and separate instructions.

Part I Information About the Partnership

A Partnership's employer identification number

B Partnership's name, address, city, state, and ZIP code

C IRS Center where partnership filed return

D ☐ Check if this is a publicly traded partnership (PTP)

Part II Information About the Partner

E Partner's identifying number

F Partner's name, address, city, state, and ZIP code

G ☐ General partner or LLC member-manager ☐ Limited partner or other LLC member

H ☐ Domestic partner ☐ Foreign partner

I What type of entity is this partner? _____

J Partner's share of profit, loss, and capital (see instructions):

	Beginning	Ending
Profit	%	%
Loss	%	%
Capital	%	%

K Partner's share of liabilities at year end:

Nonrecourse . . . . . $ _____
Qualified nonrecourse financing . $ _____
Recourse . . . . . $ _____

L Partner's capital account analysis:

Beginning capital account . . . $ _____
Capital contributed during the year $ _____
Current year increase (decrease) . $ _____
Withdrawals & distributions . . $ (_____)
Ending capital account . . . . $ _____

☐ Tax basis ☐ GAAP ☐ Section 704(b) book
☐ Other (explain)

M Did the partner contribute property with a built-in gain or loss?
☐ Yes ☐ No
If "Yes", attach statement (see instructions)

Part III Partner's Share of Current Year Income, Deductions, Credits, and Other Items

1	Ordinary business income (loss)	15	Credits
2	Net rental real estate income (loss)		
3	Other net rental income (loss)	16	Foreign transactions
4	Guaranteed payments		
5	Interest income		
6a	Ordinary dividends		
6b	Qualified dividends		
7	Royalties		
8	Net short-term capital gain (loss)		
9a	Net long-term capital gain (loss)	17	Alternative minimum tax (AMT) items
9b	Collectibles (28%) gain (loss)		
9c	Unrecaptured section 1250 gain		
10	Net section 1231 gain (loss)	18	Tax-exempt income and nondeductible expenses
11	Other income (loss)		
		19	Distributions
12	Section 179 deduction		
13	Other deductions	20	Other information
14	Self-employment earnings (loss)		

*See attached statement for additional information.

For IRS Use Only

Form **1120**
Department of the Treasury
Internal Revenue Service

U.S. Corporation Income Tax Return

For calendar year 2009 or tax year beginning _____, 2009, ending _____, 20 ____
▶ See separate instructions.

OMB No. 1545-0123
2009

A Check if:
1a Consolidated return (attach Form 851) ☐
b Life/nonlife consolidated return ☐
2 Personal holding co. (attach Sch. PH) ☐
3 Personal service corp. (see instructions) ☐
4 Schedule M-3 attached ☐

Use IRS label. Otherwise, print or type.

Name

Number, street, and room or suite no. If a P.O. box, see instructions.

City or town, state, and ZIP code

B Employer identification number

C Date incorporated

D Total assets (see instructions)
$

E Check if: (1) ☐ Initial return (2) ☐ Final return (3) ☐ Name change (4) ☐ Address change

Income	1a	Gross receipts or sales	b Less returns and allowances	c Bal ▶	1c
	2	Cost of goods sold (Schedule A, line 8)			2
	3	Gross profit. Subtract line 2 from line 1c			3
	4	Dividends (Schedule C, line 19)			4
	5	Interest			5
	6	Gross rents			6
	7	Gross royalties			7
	8	Capital gain net income (attach Schedule D (Form 1120))			8
	9	Net gain or (loss) from Form 4797, Part II, line 17 (attach Form 4797)			9
	10	Other income (see instructions—attach schedule)			10
	11	**Total income.** Add lines 3 through 10		▶	11
Deductions (See instructions for limitations on deductions.)	12	Compensation of officers (Schedule E, line 4)		▶	12
	13	Salaries and wages (less employment credits)			13
	14	Repairs and maintenance			14
	15	Bad debts			15
	16	Rents			16
	17	Taxes and licenses			17
	18	Interest			18
	19	Charitable contributions			19
	20	Depreciation from Form 4562 not claimed on Schedule A or elsewhere on return (attach Form 4562)			20
	21	Depletion			21
	22	Advertising			22
	23	Pension, profit-sharing, etc., plans			23
	24	Employee benefit programs			24
	25	Domestic production activities deduction (attach Form 8903)			25
	26	Other deductions (attach schedule)			26
	27	**Total deductions.** Add lines 12 through 26		▶	27
	28	Taxable income before net operating loss deduction and special deductions. Subtract line 27 from line 11			28
	29	**Less:** a Net operating loss deduction (see instructions) 29a			
		b Special deductions (Schedule C, line 20) 29b			29c
Tax, Refundable Credits, and Payments	30	**Taxable income.** Subtract line 29c from line 28 (see instructions)			30
	31	**Total tax** (Schedule J, line 10)			31
	32a	2008 overpayment credited to 2009 32a			
	b	2009 estimated tax payments 32b			
	c	2009 refund applied for on Form 4466 32c ( )	d Bal ▶ 32d		
	e	Tax deposited with Form 7004	32e		
	f	Credits: (1) Form 2439 (2) Form 4136	32f		
	g	Refundable credits from Form 3800, line 19c, and Form 8827, line 8c	32g		32h
	33	Estimated tax penalty (see instructions). Check if Form 2220 is attached ▶ ☐			33
	34	**Amount owed.** If line 32h is smaller than the total of lines 31 and 33, enter amount owed			34
	35	**Overpayment.** If line 32h is larger than the total of lines 31 and 33, enter amount overpaid			35
	36	Enter amount from line 35 you want: **Credited to 2010 estimated tax** ▶	**Refunded** ▶		36

Sign Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Signature of officer _____ Date _____ Title _____

May the IRS discuss this return with the preparer shown below (see instructions)? ☐ Yes ☐ No

Paid Preparer's Use Only

Preparer's signature ▶ | Date | Check if self-employed ☐ | Preparer's SSN or PTIN

Firm's name (or yours if self-employed), address, and ZIP code ▶ | EIN | Phone no.

Form 1120 (2009) Page 2

Schedule A Cost of Goods Sold (see instructions)

1	Inventory at beginning of year	1	
2	Purchases	2	
3	Cost of labor	3	
4	Additional section 263A costs (attach schedule)	4	
5	Other costs (attach schedule)	5	
6	**Total.** Add lines 1 through 5	6	
7	Inventory at end of year	7	
8	**Cost of goods sold.** Subtract line 7 from line 6. Enter here and on page 1, line 2	8	

9a Check all methods used for valuing closing inventory:

(i) ☐ Cost

(ii) ☐ Lower of cost or market

(iii) ☐ Other (Specify method used and attach explanation.) ▶

b Check if there was a writedown of subnormal goods ▶ ☐

c Check if the LIFO inventory method was adopted this tax year for any goods (if checked, attach Form 970) ▶ ☐

d If the LIFO inventory method was used for this tax year, enter percentage (or amounts) of closing inventory computed under LIFO 9d

e If property is produced or acquired for resale, do the rules of section 263A apply to the corporation? ☐ Yes ☐ No

f Was there any change in determining quantities, cost, or valuations between opening and closing inventory? If "Yes," attach explanation ☐ Yes ☐ No

Schedule C Dividends and Special Deductions (see instructions)

		(a) Dividends received	(b) %	(c) Special deductions (a) × (b)
1	Dividends from less-than-20%-owned domestic corporations (other than debt-financed stock)		70	
2	Dividends from 20%-or-more-owned domestic corporations (other than debt-financed stock)		80	
3	Dividends on debt-financed stock of domestic and foreign corporations		see instructions	
4	Dividends on certain preferred stock of less-than-20%-owned public utilities		42	
5	Dividends on certain preferred stock of 20%-or-more-owned public utilities		48	
6	Dividends from less-than-20%-owned foreign corporations and certain FSCs		70	
7	Dividends from 20%-or-more-owned foreign corporations and certain FSCs		80	
8	Dividends from wholly owned foreign subsidiaries		100	
9	**Total.** Add lines 1 through 8. See instructions for limitation			
10	Dividends from domestic corporations received by a small business investment company operating under the Small Business Investment Act of 1958		100	
11	Dividends from affiliated group members		100	
12	Dividends from certain FSCs		100	
13	Dividends from foreign corporations not included on lines 3, 6, 7, 8, 11, or 12			
14	Income from controlled foreign corporations under subpart F (attach Form(s) 5471)			
15	Foreign dividend gross-up			
16	IC-DISC and former DISC dividends not included on lines 1, 2, or 3			
17	Other dividends			
18	Deduction for dividends paid on certain preferred stock of public utilities			
19	**Total dividends.** Add lines 1 through 17. Enter here and on page 1, line 4 ▶			
20	**Total special deductions.** Add lines 9, 10, 11, 12, and 18. Enter here and on page 1, line 29b ▶			

Schedule E Compensation of Officers (see instructions for page 1, line 12)

Note: *Complete Schedule E only if total receipts (line 1a plus lines 4 through 10 on page 1) are $500,000 or more.*

	(a) Name of officer	(b) Social security number	(c) Percent of time devoted to business	Percent of corporation stock owned (d) Common	(e) Preferred	(f) Amount of compensation
1			%	%	%	
			%	%	%	
			%	%	%	
			%	%	%	
			%	%	%	

2	Total compensation of officers	
3	Compensation of officers claimed on Schedule A and elsewhere on return	
4	Subtract line 3 from line 2. Enter the result here and on page 1, line 12	

Schedule J Tax Computation (see instructions)

1	Check if the corporation is a member of a controlled group (attach Schedule O (Form 1120)) ▶ ☐				
2	Income tax. Check if a qualified personal service corporation (see instructions) ▶ ☐			2	
3	Alternative minimum tax (attach Form 4626)			3	
4	Add lines 2 and 3			4	
5a	Foreign tax credit (attach Form 1118)	5a			
b	Credit from Form 8834, line 29	5b			
c	General business credit (attach Form 3800)	5c			
d	Credit for prior year minimum tax (attach Form 8827)	5d			
e	Bond credits from Form 8912	5e			
6	**Total credits.** Add lines 5a through 5e			6	
7	Subtract line 6 from line 4			7	
8	Personal holding company tax (attach Schedule PH (Form 1120))			8	
9	Other taxes. Check if from: ☐ Form 4255 ☐ Form 8611 ☐ Form 8697 ☐ Form 8866 ☐ Form 8902 ☐ Other (attach schedule)			9	
10	**Total tax.** Add lines 7 through 9. Enter here and on page 1, line 31			10	

Schedule K Other Information (see instructions)

		Yes	No
1	Check accounting method: **a** ☐ Cash **b** ☐ Accrual **c** ☐ Other (specify) ▶		
2	See the instructions and enter the:		
a	Business activity code no. ▶		
b	Business activity ▶		
c	Product or service ▶		
3	Is the corporation a subsidiary in an affiliated group or a parent-subsidiary controlled group? If "Yes," enter name and EIN of the parent corporation ▶		
4	At the end of the tax year:		
a	Did any foreign or domestic corporation, partnership (including any entity treated as a partnership), trust, or tax-exempt organization own directly 20% or more, or own, directly or indirectly, 50% or more of the total voting power of all classes of the corporation's stock entitled to vote? If "Yes," complete Part I of Schedule G (Form 1120) (attach Schedule G)		
b	Did any individual or estate own directly 20% or more, or own, directly or indirectly, 50% or more of the total voting power of all classes of the corporation's stock entitled to vote? If "Yes", complete Part II of Schedule G (Form 1120) (attach Schedule G)		
5	At the end of the tax year, did the corporation:	**Yes**	**No**
a	Own directly 20% or more, or own, directly or indirectly, 50% or more of the total voting power of all classes of stock entitled to vote of any foreign or domestic corporation not included on **Form 851,** Affiliations Schedule? For rules of constructive ownership, see instructions If "Yes," complete (i) through (iv).		

(i) Name of Corporation	(ii) Employer Identification Number (if any)	(iii) Country of Incorporation	(iv) Percentage Owned in Voting Stock

Form 1120 (2009) Page **4**

Schedule K *Continued*

b Own directly an interest of 20% or more, or own, directly or indirectly, an interest of 50% or more in any foreign or domestic partnership (including an entity treated as a partnership) or in the beneficial interest of a trust? For rules of constructive ownership, see instructions If "Yes," complete (i) through (iv).

(i) Name of Entity	(ii) Employer Identification Number (if any)	(iii) Country of Organization	(iv) Maximum Percentage Owned in Profit, Loss, or Capital

6 During this tax year, did the corporation pay dividends (other than stock dividends and distributions in exchange for stock) in excess of the corporation's current and accumulated earnings and profits? (See sections 301 and 316.) . . . . . .
If "Yes," file **Form 5452,** Corporate Report of Nondividend Distributions.
If this is a consolidated return, answer here for the parent corporation and on Form 851 for each subsidiary.

7 At any time during the tax year, did one foreign person own, directly or indirectly, at least 25% of **(a)** the total voting power of all classes of the corporation's stock entitled to vote or **(b)** the total value of all classes of the corporation's stock? . . . .
For rules of attribution, see section 318. If "Yes," enter:
(i) Percentage owned ▶ _____ and **(ii)** Owner's country ▶ _____
(c) The corporation may have to file **Form 5472,** Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business. Enter the number of Forms 5472 attached ▶ _____

8 Check this box if the corporation issued publicly offered debt instruments with original issue discount . . . . . ▶ ☐
If checked, the corporation may have to file **Form 8281,** Information Return for Publicly Offered Original Issue Discount Instruments.

9 Enter the amount of tax-exempt interest received or accrued during the tax year ▶ $ _____

10 Enter the number of shareholders at the end of the tax year (if 100 or fewer) ▶ _____

11 If the corporation has an NOL for the tax year and is electing to forego the carryback period, check here . . . . . ▶ ☐
If the corporation is filing a consolidated return, the statement required by Regulations section 1.1502-21(b)(3) must be attached or the election will not be valid.

12 Enter the available NOL carryover from prior tax years (do not reduce it by any deduction on line 29a.) ▶ $ _____

13 Are the corporation's total receipts (line 1a plus lines 4 through 10 on page 1) for the tax year **and** its total assets at the end of the tax year less than $250,000? . . . . . .
If "Yes," the corporation is not required to complete Schedules L, M-1, and M-2 on page 5. Instead, enter the total amount of cash distributions and the book value of property distributions (other than cash) made during the tax year. ▶ $

Schedule L Balance Sheets per Books

Assets	Beginning of tax year (a)	Beginning of tax year (b)	End of tax year (c)	End of tax year (d)
1 Cash				
2a Trade notes and accounts receivable				
b Less allowance for bad debts	( )		( )	
3 Inventories				
4 U.S. government obligations				
5 Tax-exempt securities (see instructions)				
6 Other current assets (attach schedule)				
7 Loans to shareholders				
8 Mortgage and real estate loans				
9 Other investments (attach schedule)				
10a Buildings and other depreciable assets				
b Less accumulated depreciation	( )		( )	
11a Depletable assets				
b Less accumulated depletion	( )		( )	
12 Land (net of any amortization)				
13a Intangible assets (amortizable only)				
b Less accumulated amortization	( )		( )	
14 Other assets (attach schedule)				
15 Total assets				
Liabilities and Shareholders' Equity				
16 Accounts payable				
17 Mortgages, notes, bonds payable in less than 1 year				
18 Other current liabilities (attach schedule)				
19 Loans from shareholders				
20 Mortgages, notes, bonds payable in 1 year or more				
21 Other liabilities (attach schedule)				
22 Capital stock: a Preferred stock				
b Common stock				
23 Additional paid-in capital				
24 Retained earnings—Appropriated (attach schedule)				
25 Retained earnings—Unappropriated				
26 Adjustments to shareholders' equity (attach schedule)				
27 Less cost of treasury stock		( )		( )
28 Total liabilities and shareholders' equity				

Schedule M-1 Reconciliation of Income (Loss) per Books With Income per Return

Note: Schedule M-3 required instead of Schedule M-1 if total assets are $10 million or more—see instructions

1	Net income (loss) per books	7	Income recorded on books this year not included on this return (itemize): Tax-exempt interest $
2	Federal income tax per books		
3	Excess of capital losses over capital gains		
4	Income subject to tax not recorded on books this year (itemize):	8	Deductions on this return not charged against book income this year (itemize):
5	Expenses recorded on books this year not deducted on this return (itemize):	a	Depreciation $
a	Depreciation $	b	Charitable contributions $
b	Charitable contributions $		
c	Travel and entertainment $		
6	Add lines 1 through 5	9	Add lines 7 and 8
		10	Income (page 1, line 28)—line 6 less line 9

Schedule M-2 Analysis of Unappropriated Retained Earnings per Books (Line 25, Schedule L)

1	Balance at beginning of year	5	Distributions: a Cash
2	Net income (loss) per books		b Stock
3	Other increases (itemize):		c Property
		6	Other decreases (itemize):
		7	Add lines 5 and 6
4	Add lines 1, 2, and 3	8	Balance at end of year (line 4 less line 7)

SCHEDULE M-3 (Form 1120)

Department of the Treasury
Internal Revenue Service

Net Income (Loss) Reconciliation for Corporations With Total Assets of $10 Million or More

▶ Attach to Form 1120 or 1120-C.
▶ See separate instructions.

OMB No. 1545-0123

2009

Name of corporation (common parent, if consolidated return) | Employer identification number

Check applicable box(es): (1) ☐ Non-consolidated return (2) ☐ Consolidated return (Form 1120 only)
(3) ☐ Mixed 1120/L/PC group (4) ☐ Dormant subsidiaries schedule attached

Part I Financial Information and Net Income (Loss) Reconciliation (see instructions)

1a Did the corporation file SEC Form 10-K for its income statement period ending with or within this tax year?
☐ **Yes.** Skip lines 1b and 1c and complete lines 2a through 11 with respect to that SEC Form 10-K.
☐ **No.** Go to line 1b. See instructions if multiple non-tax-basis income statements are prepared.

b Did the corporation prepare a certified audited non-tax-basis income statement for that period?
☐ **Yes.** Skip line 1c and complete lines 2a through 11 with respect to that income statement.
☐ **No.** Go to line 1c.

c Did the corporation prepare a non-tax-basis income statement for that period?
☐ **Yes.** Complete lines 2a through 11 with respect to that income statement.
☐ **No.** Skip lines 2a through 3c and enter the corporation's net income (loss) per its books and records on line 4a.

2a Enter the income statement period: Beginning _____ Ending _____

b Has the corporation's income statement been restated for the income statement period on line 2a?
☐ **Yes.** (If "Yes," attach an explanation and the amount of each item restated.)
☐ **No.**

c Has the corporation's income statement been restated for any of the five income statement periods preceding the period on line 2a?
☐ **Yes.** (If "Yes," attach an explanation and the amount of each item restated.)
☐ **No.**

3a Is any of the corporation's voting common stock publicly traded?
☐ **Yes.**
☐ **No.** If "No," go to line 4a.

b Enter the symbol of the corporation's primary U.S. publicly traded voting common stock . . . . . ▶

c Enter the nine-digit CUSIP number of the corporation's primary publicly traded voting common stock . . . . . ▶

4a	Worldwide consolidated net income (loss) from income statement source identified in Part I, line 1	4a	
b	Indicate accounting standard used for line 4a (see instructions): (1) ☐ GAAP (2) ☐ IFRS (3) ☐ Statutory (4) ☐ Tax-basis (5) ☐ Other (specify) _____		
5a	Net income from nonincludible foreign entities (attach schedule)	5a	( )
b	Net loss from nonincludible foreign entities (attach schedule and enter as a positive amount)	5b	
6a	Net income from nonincludible U.S. entities (attach schedule)	6a	( )
b	Net loss from nonincludible U.S. entities (attach schedule and enter as a positive amount)	6b	
7a	Net income (loss) of other includible foreign disregarded entities (attach schedule)	7a	
b	Net income (loss) of other includible U.S. disregarded entities (attach schedule)	7b	
c	Net income (loss) of other includible entities (attach schedule)	7c	
8	Adjustment to eliminations of transactions between includible entities and nonincludible entities (attach schedule)	8	
9	Adjustment to reconcile income statement period to tax year (attach schedule)	9	
10a	Intercompany dividend adjustments to reconcile to line 11 (attach schedule)	10a	
b	Other statutory accounting adjustments to reconcile to line 11 (attach schedule)	10b	
c	Other adjustments to reconcile to amount on line 11 (attach schedule)	10c	
11	**Net income (loss) per income statement of includible corporations.** Combine lines 4 through 10	11	

Note. Part I, line 11, must equal the amount on Part II, line 30, column (a), and Schedule M-2, line 2.

12 Enter the total amount (not just the corporation's share) of the assets and liabilities of all entities included or removed on the following lines.

		Total Assets	Total Liabilities
a	Included on Part I, line 4 ▶		
b	Removed on Part I, line 5 ▶		
c	Removed on Part I, line 6 ▶		
d	Included on Part I, line 7 ▶		

Schedule M-3 (Form 1120) 2009 Page 2

Name of corporation (common parent, if consolidated return) | Employer identification number

Check applicable box(es): (1) ☐ Consolidated group (2) ☐ Parent corp (3) ☐ Consolidated eliminations (4) ☐ Subsidiary corp (5) ☐ Mixed 1120/L/PC group
Check if a sub-consolidated: (6) ☐ 1120 group (7) ☐ 1120 eliminations

Name of subsidiary (if consolidated return) | Employer identification number

Part II Reconciliation of Net Income (Loss) per Income Statement of Includible Corporations With Taxable Income per Return (see instructions)

Income (Loss) Items (Attach schedules for lines 1 through 11)	(a) Income (Loss) per Income Statement	(b) Temporary Difference	(c) Permanent Difference	(d) Income (Loss) per Tax Return
1 Income (loss) from equity method foreign corporations				
2 Gross foreign dividends not previously taxed				
3 Subpart F, QEF, and similar income inclusions				
4 Section 78 gross-up				
5 Gross foreign distributions previously taxed				
6 Income (loss) from equity method U.S. corporations				
7 U.S. dividends not eliminated in tax consolidation				
8 Minority interest for includible corporations				
9 Income (loss) from U.S. partnerships				
10 Income (loss) from foreign partnerships				
11 Income (loss) from other pass-through entities				
12 Items relating to reportable transactions (attach details)				
13 Interest income (attach Form 8916-A)				
14 Total accrual to cash adjustment				
15 Hedging transactions				
16 Mark-to-market income (loss)				
17 Cost of goods sold (attach Form 8916-A)	( )			( )
18 Sale versus lease (for sellers and/or lessors)				
19 Section 481(a) adjustments				
20 Unearned/deferred revenue				
21 Income recognition from long-term contracts				
22 Original issue discount and other imputed interest				
23a Income statement gain/loss on sale, exchange, abandonment, worthlessness, or other disposition of assets other than inventory and pass-through entities				
b Gross capital gains from Schedule D, excluding amounts from pass-through entities				
c Gross capital losses from Schedule D, excluding amounts from pass-through entities, abandonment losses, and worthless stock losses				
d Net gain/loss reported on Form 4797, line 17, excluding amounts from pass-through entities, abandonment losses, and worthless stock losses				
e Abandonment losses				
f Worthless stock losses (attach details)				
g Other gain/loss on disposition of assets other than inventory				
24 Capital loss limitation and carryforward used				
25 Other income (loss) items with differences (attach schedule)				
26 **Total income (loss) items.** Combine lines 1 through 25				
27 **Total expense/deduction items** (from Part III, line 36)				
28 Other items with no differences				
29a Mixed groups, see instructions. All others, combine lines 26 through 28				
b PC insurance subgroup reconciliation totals				
c Life insurance subgroup reconciliation totals				
30 **Reconciliation totals.** Combine lines 29a through 29c				

Note. Line 30, column (a), must equal the amount on Part I, line 11, and column (d) must equal Form 1120, page 1, line 28.

Schedule M-3 (Form 1120) 2009 Page 3

Name of corporation (common parent, if consolidated return) | Employer identification number

Check applicable box(es): (1) ☐ Consolidated group (2) ☐ Parent corp (3) ☐ Consolidated eliminations (4) ☐ Subsidiary corp (5) ☐ Mixed 1120/L/PC group
Check if a sub-consolidated: (6) ☐ 1120 group (7) ☐ 1120 eliminations

Name of subsidiary (if consolidated return) | Employer identification number

Part III Reconciliation of Net Income (Loss) per Income Statement of Includible Corporations With Taxable Income per Return—Expense/Deduction Items (see instructions)

Expense/Deduction Items	(a) Expense per Income Statement	(b) Temporary Difference	(c) Permanent Difference	(d) Deduction per Tax Return
1 U.S. current income tax expense				
2 U.S. deferred income tax expense				
3 State and local current income tax expense				
4 State and local deferred income tax expense				
5 Foreign current income tax expense (other than foreign withholding taxes)				
6 Foreign deferred income tax expense				
7 Foreign withholding taxes				
8 Interest expense (attach Form 8916-A)				
9 Stock option expense				
10 Other equity-based compensation				
11 Meals and entertainment				
12 Fines and penalties				
13 Judgments, damages, awards, and similar costs				
14 Parachute payments				
15 Compensation with section 162(m) limitation				
16 Pension and profit-sharing				
17 Other post-retirement benefits				
18 Deferred compensation				
19 Charitable contribution of cash and tangible property				
20 Charitable contribution of intangible property				
21 Charitable contribution limitation/carryforward				
22 Domestic production activities deduction				
23 Current year acquisition or reorganization investment banking fees				
24 Current year acquisition or reorganization legal and accounting fees				
25 Current year acquisition/reorganization other costs				
26 Amortization/impairment of goodwill				
27 Amortization of acquisition, reorganization, and start-up costs				
28 Other amortization or impairment write-offs				
29 Section 198 environmental remediation costs				
30 Depletion				
31 Depreciation				
32 Bad debt expense				
33 Corporate owned life insurance premiums				
34 Purchase versus lease (for purchasers and/or lessees)				
35 Other expense/deduction items with differences (attach schedule)				
36 **Total expense/deduction items.** Combine lines 1 through 35. Enter here and on Part II, line 27, reporting positive amounts as negative and negative amounts as positive				

Form **1120S**

Department of the Treasury
Internal Revenue Service

U.S. Income Tax Return for an S Corporation

▶ **Do not file this form unless the corporation has filed or is attaching Form 2553 to elect to be an S corporation.**

▶ **See separate instructions.**

OMB No. 1545-0130

2009

For calendar year 2009 or tax year beginning , 2009, ending , 20

A S election effective date	**Use IRS label. Otherwise, print or type.** Name	**D** Employer identification number
B Business activity code number *(see instructions)*	Number, street, and room or suite no. If a P.O. box, see instructions.	**E** Date incorporated
C Check if Sch. M-3 attached ☐	City or town, state, and ZIP code	**F** Total assets *(see instructions)* $

G Is the corporation electing to be an S corporation beginning with this tax year? ☐ Yes ☐ No If "Yes," attach Form 2553 if not already filed

H Check if: **(1)** ☐ Final return **(2)** ☐ Name change **(3)** ☐ Address change **(4)** ☐ Amended return **(5)** ☐ S election termination or revocation

I Enter the number of shareholders who were shareholders during any part of the tax year . . . . . ▶

Caution. *Include* ***only*** *trade or business income and expenses on lines 1a through 21. See the instructions for more information.*

Income	1a	Gross receipts or sales	b Less returns and allowances	c Bal ▶	1c
	2	Cost of goods sold (Schedule A, line 8)			2
	3	Gross profit. Subtract line 2 from line 1c			3
	4	Net gain (loss) from Form 4797, Part II, line 17 *(attach Form 4797)*			4
	5	Other income (loss) *(see instructions—attach statement)*			5
	6	**Total income (loss).** Add lines 3 through 5		▶	6
Deductions (see instructions for limitations)	7	Compensation of officers			7
	8	Salaries and wages (less employment credits)			8
	9	Repairs and maintenance			9
	10	Bad debts			10
	11	Rents			11
	12	Taxes and licenses			12
	13	Interest			13
	14	Depreciation not claimed on Schedule A or elsewhere on return (*attach Form 4562*)			14
	15	Depletion **(Do not deduct oil and gas depletion.)**			15
	16	Advertising			16
	17	Pension, profit-sharing, etc., plans			17
	18	Employee benefit programs			18
	19	Other deductions (*attach statement*)			19
	20	**Total deductions.** Add lines 7 through 19		▶	20
	21	**Ordinary business income (loss).** Subtract line 20 from line 6			21
Tax and Payments	22a	Excess net passive income or LIFO recapture tax (*see instructions*)	22a		
	b	Tax from Schedule D (Form 1120S)	22b		
	c	Add lines 22a and 22b (*see instructions for additional taxes*)			22c
	23a	2009 estimated tax payments and 2008 overpayment credited to 2009	23a		
	b	Tax deposited with Form 7004	23b		
	c	Credit for federal tax paid on fuels (*attach Form 4136*)	23c		
	d	Add lines 23a through 23c			23d
	24	Estimated tax penalty (*see instructions*). Check if Form 2220 is attached		▶ ☐	24
	25	**Amount owed.** If line 23d is smaller than the total of lines 22c and 24, enter amount owed			25
	26	**Overpayment.** If line 23d is larger than the total of lines 22c and 24, enter amount overpaid			26
	27	Enter amount from line 26 **Credited to 2010 estimated tax** ▶	**Refunded** ▶		27

Sign Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

▶ Signature of officer | Date | ▶ Title

May the IRS discuss this return with the preparer shown below (see instructions)? ☐ Yes ☐ No

Paid Preparer's Use Only

Preparer's signature ▶	Date	Check if self-employed ☐	Preparer's SSN or PTIN
Firm's name (or yours if self-employed), address, and ZIP code ▶			EIN Phone no.

Schedule A Cost of Goods Sold (see instructions)

1	Inventory at beginning of year	1	
2	Purchases	2	
3	Cost of labor	3	
4	Additional section 263A costs (*attach statement*)	4	
5	Other costs (*attach statement*)	5	
6	**Total.** Add lines 1 through 5	6	
7	Inventory at end of year	7	
8	**Cost of goods sold.** Subtract line 7 from line 6. Enter here and on page 1, line 2	8	

9a Check all methods used for valuing closing inventory: (i) ☐ Cost as described in Regulations section 1.471-3
(ii) ☐ Lower of cost or market as described in Regulations section 1.471-4
(iii) ☐ Other (Specify method used and attach explanation.) ▶ _____

b Check if there was a writedown of subnormal goods as described in Regulations section 1.471-2(c) ▶ ☐

c Check if the LIFO inventory method was adopted this tax year for any goods (if checked, attach Form 970) ▶ ☐

d If the LIFO inventory method was used for this tax year, enter percentage (or amounts) of closing inventory computed under LIFO 9d

e If property is produced or acquired for resale, do the rules of section 263A apply to the corporation? ☐ Yes ☐ No

f Was there any change in determining quantities, cost, or valuations between opening and closing inventory? ☐ Yes ☐ No
If "Yes," attach explanation.

Schedule B Other Information (see instructions)

		Yes	No
1	Check accounting method: **a** ☐ Cash **b** ☐ Accrual **c** ☐ Other (specify) ▶ _____		
2	See the instructions and enter the: **a** Business activity ▶ _____ **b** Product or service ▶ _____		
3	At the end of the tax year, did the corporation own, directly or indirectly, 50% or more of the voting stock of a domestic corporation? (For rules of attribution, see section 267(c).) If "Yes," attach a statement showing: **(a)** name and employer identification number (EIN), **(b)** percentage owned, and **(c)** if 100% owned, was a QSub election made?		
4	Has this corporation filed, or is it required to file, a return under section 6111 to provide information on any reportable transaction?		
5	Check this box if the corporation issued publicly offered debt instruments with original issue discount ▶ ☐ If checked, the corporation may have to file **Form 8281,** Information Return for Publicly Offered Original Issue Discount Instruments.		
6	If the corporation: **(a)** was a C corporation before it elected to be an S corporation **or** the corporation acquired an asset with a basis determined by reference to its basis (or the basis of any other property) in the hands of a C corporation **and (b)** has net unrealized built-in gain (defined in section 1374(d)(1)) in excess of the net recognized built-in gain from prior years, enter the net unrealized built-in gain reduced by net recognized built-in gain from prior years ▶ $ _____		
7	Enter the accumulated earnings and profits of the corporation at the end of the tax year. $ _____		
8	Are the corporation's total receipts (*see instructions*) for the tax year **and** its total assets at the end of the tax year less than $250,000? If "Yes," the corporation is not required to complete Schedules L and M-1		

Schedule K Shareholders' Pro Rata Share Items

				Total amount
Income (Loss)	1	Ordinary business income (loss) (page 1, line 21)	1	
	2	Net rental real estate income (loss) (*attach Form 8825*)	2	
	3a	Other gross rental income (loss) 3a		
	b	Expenses from other rental activities (*attach statement*) 3b		
	c	Other net rental income (loss). Subtract line 3b from line 3a	3c	
	4	Interest income	4	
	5	Dividends: **a** Ordinary dividends	5a	
		b Qualified dividends 5b		
	6	Royalties	6	
	7	Net short-term capital gain (loss) (*attach Schedule D (Form 1120S)*)	7	
	8a	Net long-term capital gain (loss) (*attach Schedule D (Form 1120S)*)	8a	
	b	Collectibles (28%) gain (loss) 8b		
	c	Unrecaptured section 1250 gain (*attach statement*) 8c		
	9	Net section 1231 gain (loss) (*attach Form 4797*)	9	
	10	Other income (loss) (*see instructions*) Type ▶	10	

		Shareholders' Pro Rata Share Items (continued)		Total amount
Deductions	11	Section 179 deduction (*attach Form 4562*)	11	
	12a	Contributions	12a	
	b	Investment interest expense	12b	
	c	Section 59(e)(2) expenditures (1) Type ▶ _____ (2) Amount ▶	12c(2)	
	d	Other deductions (*see instructions*) Type ▶	12d	
Credits	13a	Low-income housing credit (section 42(j)(5))	13a	
	b	Low-income housing credit (other)	13b	
	c	Qualified rehabilitation expenditures (rental real estate) (*attach Form 3468*)	13c	
	d	Other rental real estate credits (*see instructions*) Type ▶ _____	13d	
	e	Other rental credits (*see instructions*) Type ▶ _____	13e	
	f	Alcohol and cellulosic biofuel fuels credit (*attach Form 6478*)	13f	
	g	Other credits (*see instructions*) Type ▶	13g	
Foreign Transactions	14a	Name of country or U.S. possession ▶ _____		
	b	Gross income from all sources	14b	
	c	Gross income sourced at shareholder level	14c	
		Foreign gross income sourced at corporate level		
	d	Passive category	14d	
	e	General category	14e	
	f	Other (*attach statement*)	14f	
		Deductions allocated and apportioned at shareholder level		
	g	Interest expense	14g	
	h	Other	14h	
		Deductions allocated and apportioned at corporate level to foreign source income		
	i	Passive category	14i	
	j	General category	14j	
	k	Other (*attach statement*)	14k	
		Other information		
	l	Total foreign taxes (check one): ▶ ☐ Paid ☐ Accrued	14l	
	m	Reduction in taxes available for credit (*attach statement*)	14m	
	n	Other foreign tax information (*attach statement*)		
Alternative Minimum Tax (AMT) Items	15a	Post-1986 depreciation adjustment	15a	
	b	Adjusted gain or loss	15b	
	c	Depletion (other than oil and gas)	15c	
	d	Oil, gas, and geothermal properties—gross income	15d	
	e	Oil, gas, and geothermal properties—deductions	15e	
	f	Other AMT items (*attach statement*)	15f	
Items Affecting Shareholder Basis	16a	Tax-exempt interest income	16a	
	b	Other tax-exempt income	16b	
	c	Nondeductible expenses	16c	
	d	Property distributions	16d	
	e	Repayment of loans from shareholders	16e	
Other Information	17a	Investment income	17a	
	b	Investment expenses	17b	
	c	Dividend distributions paid from accumulated earnings and profits	17c	
	d	Other items and amounts (*attach statement*)		
Reconciliation	18	**Income/loss reconciliation.** Combine the amounts on lines 1 through 10 in the far right column. From the result, subtract the sum of the amounts on lines 11 through 12d and 14l	18	

Form 1120S (2009) Page 4

Schedule L Balance Sheets per Books

	Assets	Beginning of tax year (a)	Beginning of tax year (b)	End of tax year (c)	End of tax year (d)
1	Cash				
2a	Trade notes and accounts receivable				
b	Less allowance for bad debts	( )		( )	
3	Inventories				
4	U.S. government obligations				
5	Tax-exempt securities (*see instructions*)				
6	Other current assets (*attach statement*)				
7	Loans to shareholders				
8	Mortgage and real estate loans				
9	Other investments (*attach statement*)				
10a	Buildings and other depreciable assets				
b	Less accumulated depreciation	( )		( )	
11a	Depletable assets				
b	Less accumulated depletion	( )		( )	
12	Land (net of any amortization)				
13a	Intangible assets (amortizable only)				
b	Less accumulated amortization	( )		( )	
14	Other assets (*attach statement*)				
15	Total assets				
	Liabilities and Shareholders' Equity				
16	Accounts payable				
17	Mortgages, notes, bonds payable in less than 1 year				
18	Other current liabilities (*attach statement*)				
19	Loans from shareholders				
20	Mortgages, notes, bonds payable in 1 year or more				
21	Other liabilities (*attach statement*)				
22	Capital stock				
23	Additional paid-in capital				
24	Retained earnings				
25	Adjustments to shareholders' equity (*attach statement*)				
26	Less cost of treasury stock		( )		( )
27	Total liabilities and shareholders' equity				

Schedule M-1 Reconciliation of Income (Loss) per Books With Income (Loss) per Return

Note: Schedule M-3 required instead of Schedule M-1 if total assets are $10 million or more—see instructions

1	Net income (loss) per books		5	Income recorded on books this year not included on Schedule K, lines 1 through 10 (itemize): a Tax-exempt interest $
2	Income included on Schedule K, lines 1, 2, 3c, 4, 5a, 6, 7, 8a, 9, and 10, not recorded on books this year (itemize):			
3	Expenses recorded on books this year not included on Schedule K, lines 1 through 12 and 14l (itemize): a Depreciation $ b Travel and entertainment $		6	Deductions included on Schedule K, lines 1 through 12 and 14l, not charged against book income this year (itemize): a Depreciation $
4	Add lines 1 through 3		7	Add lines 5 and 6
			8	Income (loss) (Schedule K, line 18). Line 4 less line 7

Schedule M-2 Analysis of Accumulated Adjustments Account, Other Adjustments Account, and Shareholders' Undistributed Taxable Income Previously Taxed (see instructions)

		(a) Accumulated adjustments account	(b) Other adjustments account	(c) Shareholders' undistributed taxable income previously taxed
1	Balance at beginning of tax year			
2	Ordinary income from page 1, line 21			
3	Other additions			
4	Loss from page 1, line 21	( )		
5	Other reductions	( )	( )	
6	Combine lines 1 through 5			
7	Distributions other than dividend distributions			
8	Balance at end of tax year. Subtract line 7 from line 6			

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☐ Final K-1 ☐ Amended K-1 OMB No. 1545-0130

Schedule K-1 (Form 1120S)
Department of the Treasury
Internal Revenue Service

2009

For calendar year 2009, or tax year beginning _____, 2009 ending _____, 20_____

Shareholder's Share of Income, Deductions, Credits, etc.

▶ See back of form and separate instructions.

Part I Information About the Corporation

A Corporation's employer identification number

B Corporation's name, address, city, state, and ZIP code

C IRS Center where corporation filed return

Part II Information About the Shareholder

D Shareholder's identifying number

E Shareholder's name, address, city, state, and ZIP code

F Shareholder's percentage of stock ownership for tax year _____ %

For IRS Use Only

Part III Shareholder's Share of Current Year Income, Deductions, Credits, and Other Items

1	Ordinary business income (loss)	13	Credits
2	Net rental real estate income (loss)		
3	Other net rental income (loss)		
4	Interest income		
5a	Ordinary dividends		
5b	Qualified dividends	14	Foreign transactions
6	Royalties		
7	Net short-term capital gain (loss)		
8a	Net long-term capital gain (loss)		
8b	Collectibles (28%) gain (loss)		
8c	Unrecaptured section 1250 gain		
9	Net section 1231 gain (loss)		
10	Other income (loss)	15	Alternative minimum tax (AMT) items
11	Section 179 deduction	16	Items affecting shareholder basis
12	Other deductions		
		17	Other information

* See attached statement for additional information.

Form **2553**
(Rev. December 2007)
Department of the Treasury
Internal Revenue Service

Election by a Small Business Corporation

(Under section 1362 of the Internal Revenue Code)

► **See Parts II and III on page 3 and the separate instructions.**
► **The corporation can fax this form to the IRS (see separate instructions).**

OMB No. 1545-0146

Note. This election to be an S corporation can be accepted only if all the tests are met under **Who May Elect** on page 1 of the instructions; all shareholders have signed the consent statement; an officer has signed below; and the exact name and address of the corporation and other required form information are provided.

Part I Election Information

Type or Print		
	Name (see instructions)	**A** Employer identification number
	Number, street, and room or suite no. (If a P.O. box, see instructions.)	**B** Date incorporated
	City or town, state, and ZIP code	**C** State of incorporation

D Check the applicable box(es) if the corporation, after applying for the EIN shown in **A** above, changed its ☐ name or ☐ address

E Election is to be effective for tax year beginning (month, day, year) (see instructions) . . . . . ► / /

Caution. A corporation (entity) making the election for its first tax year in existence will usually enter the beginning date of a short tax year that begins on a date other than January 1.

F Selected tax year:

(1) ☐ Calendar year
(2) ☐ Fiscal year ending (month and day) ► _____
(3) ☐ 52-53-week year ending with reference to the month of December
(4) ☐ 52-53-week year ending with reference to the month of ► _____

If box (2) or (4) is checked, complete Part II

G If more than 100 shareholders are listed for item J (see page 2), check this box if treating members of a family as one shareholder results in no more than 100 shareholders (see test 2 under **Who May Elect** in the instructions) ► ☐

H Name and title of officer or legal representative who the IRS may call for more information	**I** Telephone number of officer or legal representative ( )

If this S corporation election is being filed with Form 1120S, I declare that I had reasonable cause for not filing Form 2553 timely, and if this election is made by an entity eligible to elect to be treated as a corporation, I declare that I also had reasonable cause for not filing an entity classification election timely. See below for my explanation of the reasons the election or elections were not made on time (see instructions).

Sign Here

Under penalties of perjury, I declare that I have examined this election, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete.

Signature of officer	Title	Date

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 18629R Form **2553** (Rev. 12-2007)

Part I Election Information (continued)

J Name and address of each shareholder or former shareholder required to consent to the election. (See the instructions for column K.)	K Shareholders' Consent Statement. Under penalties of perjury, we declare that we consent to the election of the above-named corporation to be an S corporation under section 1362(a) and that we have examined this consent statement, including accompanying schedules and statements, and to the best of our knowledge and belief, it is true, correct, and complete. We understand our consent is binding and may not be withdrawn after the corporation has made a valid election. (Sign and date below.)		L Stock owned or percentage of ownership (see instructions)		M Social security number or employer identification number (see instructions)	N Shareholder's tax year ends (month and day)
	Signature	Date	Number of shares or percentage of ownership	Date(s) acquired		

Form **4562**

Department of the Treasury
Internal Revenue Service (99)

Depreciation and Amortization
(Including Information on Listed Property)

▶ See separate instructions. ▶ Attach to your tax return.

OMB No. 1545-0172

2009

Attachment Sequence No. **67**

Name(s) shown on return | Business or activity to which this form relates | Identifying number

Part I **Election To Expense Certain Property Under Section 179**

Note: *If you have any listed property, complete Part V before you complete Part I.*

1	Maximum amount. See the instructions for a higher limit for certain businesses	1	$250,000
2	Total cost of section 179 property placed in service (see instructions)	2	
3	Threshold cost of section 179 property before reduction in limitation (see instructions)	3	$800,000
4	Reduction in limitation. Subtract line 3 from line 2. If zero or less, enter -0-	4	
5	Dollar limitation for tax year. Subtract line 4 from line 1. If zero or less, enter -0-. If married filing separately, see instructions	5	

6	(a) Description of property	(b) Cost (business use only)	(c) Elected cost

7	Listed property. Enter the amount from line 29	7	
8	Total elected cost of section 179 property. Add amounts in column (c), lines 6 and 7	8	
9	Tentative deduction. Enter the **smaller** of line 5 or line 8	9	
10	Carryover of disallowed deduction from line 13 of your 2008 Form 4562	10	
11	Business income limitation. Enter the smaller of business income (not less than zero) or line 5 (see instructions)	11	
12	Section 179 expense deduction. Add lines 9 and 10, but do not enter more than line 11	12	
13	Carryover of disallowed deduction to 2010. Add lines 9 and 10, less line 12 ▶	13	

Note: *Do not use Part II or Part III below for listed property. Instead, use Part V.*

Part II **Special Depreciation Allowance and Other Depreciation (Do not** include listed property.) (See instructions.)

14	Special depreciation allowance for qualified property (other than listed property) placed in service during the tax year (see instructions)	14	
15	Property subject to section 168(f)(1) election	15	
16	Other depreciation (including ACRS)	16	

Part III **MACRS Depreciation (Do not** include listed property.) (See instructions.)

Section A

17	MACRS deductions for assets placed in service in tax years beginning before 2009	17	
18	If you are electing to group any assets placed in service during the tax year into one or more general asset accounts, check here ▶ ☐		

Section B—Assets Placed in Service During 2009 Tax Year Using the General Depreciation System

(a) Classification of property	(b) Month and year placed in service	(c) Basis for depreciation (business/investment use only—see instructions)	(d) Recovery period	(e) Convention	(f) Method	(g) Depreciation deduction
19a 3-year property						
b 5-year property						
c 7-year property						
d 10-year property						
e 15-year property						
f 20-year property						
g 25-year property			25 yrs.		S/L	
h Residential rental property			27.5 yrs.	MM	S/L	
			27.5 yrs.	MM	S/L	
i Nonresidential real property			39 yrs.	MM	S/L	
				MM	S/L	

Section C—Assets Placed in Service During 2009 Tax Year Using the Alternative Depreciation System

20a Class life					S/L	
b 12-year			12 yrs.		S/L	
c 40-year			40 yrs.	MM	S/L	

Part IV **Summary** (See instructions.)

21	Listed property. Enter amount from line 28	21	
22	**Total.** Add amounts from line 12, lines 14 through 17, lines 19 and 20 in column (g), and line 21. Enter here and on the appropriate lines of your return. Partnerships and S corporations—see instructions	22	
23	For assets shown above and placed in service during the current year, enter the portion of the basis attributable to section 263A costs	23	

Form 4562 (2009) Page **2**

Part V **Listed Property** (Include automobiles, certain other vehicles, cellular telephones, certain computers, and property used for entertainment, recreation, or amusement.)

Note: *For any vehicle for which you are using the standard mileage rate or deducting lease expense, complete* ***only*** *24a, 24b, columns (a) through (c) of Section A, all of Section B, and Section C if applicable.*

Section A—Depreciation and Other Information (Caution: *See the instructions for limits for passenger automobiles.***)**

24a Do you have evidence to support the business/investment use claimed? ☐ **Yes** ☐ **No** **24b** If "Yes," is the evidence written? ☐ **Yes** ☐ **No**

(a) Type of property (list vehicles first)	(b) Date placed in service	(c) Business/ investment use percentage	(d) Cost or other basis	(e) Basis for depreciation (business/investment use only)	(f) Recovery period	(g) Method/ Convention	(h) Depreciation deduction	(i) Elected section 179 cost
25 Special depreciation allowance for qualified listed property placed in service during the tax year and used more than 50% in a qualified business use (see instructions)						**25**		
26 Property used more than 50% in a qualified business use:								
		%						
		%						
		%						
27 Property used 50% or less in a qualified business use:								
		%				S/L –		
		%				S/L –		
		%				S/L –		
28 Add amounts in column (h), lines 25 through 27. Enter here and on line 21, page 1 . . .						**28**		
29 Add amounts in column (i), line 26. Enter here and on line 7, page 1							**29**	

Section B—Information on Use of Vehicles

Complete this section for vehicles used by a sole proprietor, partner, or other "more than 5% owner," or related person. If you provided vehicles to your employees, first answer the questions in Section C to see if you meet an exception to completing this section for those vehicles.

	(a) Vehicle 1		(b) Vehicle 2		(c) Vehicle 3		(d) Vehicle 4		(e) Vehicle 5		(f) Vehicle 6	
30 Total business/investment miles driven during the year (**do not** include commuting miles)												
31 Total commuting miles driven during the year												
32 Total other personal (noncommuting) miles driven												
33 Total miles driven during the year. Add lines 30 through 32												
	Yes	**No**	**Yes**	**No**	**Yes**	**No**	**Yes**	**No**	**Yes**	**No**	**Yes**	**No**
34 Was the vehicle available for personal use during off-duty hours?												
35 Was the vehicle used primarily by a more than 5% owner or related person?												
36 Is another vehicle available for personal use?												

Section C—Questions for Employers Who Provide Vehicles for Use by Their Employees

Answer these questions to determine if you meet an exception to completing Section B for vehicles used by employees who **are not** more than 5% owners or related persons (see instructions).

	Yes	**No**
37 Do you maintain a written policy statement that prohibits all personal use of vehicles, including commuting, by your employees?		
38 Do you maintain a written policy statement that prohibits personal use of vehicles, except commuting, by your employees? See the instructions for vehicles used by corporate officers, directors, or 1% or more owners . . .		
39 Do you treat all use of vehicles by employees as personal use?		
40 Do you provide more than five vehicles to your employees, obtain information from your employees about the use of the vehicles, and retain the information received?		
41 Do you meet the requirements concerning qualified automobile demonstration use? (See instructions.) . .		

Note: *If your answer to 37, 38, 39, 40, or 41 is "Yes," do not complete Section B for the covered vehicles.*

Part VI **Amortization**

(a) Description of costs	(b) Date amortization begins	(c) Amortizable amount	(d) Code section	(e) Amortization period or percentage	(f) Amortization for this year
42 Amortization of costs that begins during your 2009 tax year (see instructions):					
43 Amortization of costs that began before your 2009 tax year				**43**	
44 **Total.** Add amounts in column (f). See the instructions for where to report				**44**	

Form **4626**

Department of the Treasury
Internal Revenue Service

Alternative Minimum Tax—Corporations

▶ See separate instructions.
▶ Attach to the corporation's tax return.

OMB No. 1545-0175

2009

Name

Employer identification number

Part I Alternative Minimum Tax Computation

Note: *See the instructions to find out if the corporation is a small corporation exempt from the alternative minimum tax (AMT) under section 55(e).*

1	Taxable income or (loss) before net operating loss deduction			1
2	**Adjustments and preferences:**			
a	Depreciation of post-1986 property			2a
b	Amortization of certified pollution control facilities			2b
c	Amortization of mining exploration and development costs			2c
d	Amortization of circulation expenditures (personal holding companies only)			2d
e	Adjusted gain or loss			2e
f	Long-term contracts			2f
g	Merchant marine capital construction funds			2g
h	Section 833(b) deduction (Blue Cross, Blue Shield, and similar type organizations only)			2h
i	Tax shelter farm activities (personal service corporations only)			2i
j	Passive activities (closely held corporations and personal service corporations only)			2j
k	Loss limitations			2k
l	Depletion			2l
m	Tax-exempt interest income from specified private activity bonds			2m
n	Intangible drilling costs			2n
o	Other adjustments and preferences			2o
3	Pre-adjustment alternative minimum taxable income (AMTI). Combine lines 1 through 2o			3
4	**Adjusted current earnings (ACE) adjustment:**			
a	ACE from line 10 of the ACE worksheet in the instructions	4a		
b	Subtract line 3 from line 4a. If line 3 exceeds line 4a, enter the difference as a negative amount (see instructions)	4b		
c	Multiply line 4b by 75% (.75). Enter the result as a positive amount	4c		
d	Enter the excess, if any, of the corporation's total increases in AMTI from prior year ACE adjustments over its total reductions in AMTI from prior year ACE adjustments (see instructions). **Note:** *You* ***must*** *enter an amount on line 4d (even if line 4b is positive)*	4d		
e	ACE adjustment. • If line 4b is zero or more, enter the amount from line 4c • If line 4b is less than zero, enter the **smaller** of line 4c or line 4d as a negative amount			4e
5	Combine lines 3 and 4e. If zero or less, stop here; the corporation does not owe any AMT			5
6	Alternative tax net operating loss deduction (see instructions)			6
7	**Alternative minimum taxable income.** Subtract line 6 from line 5. If the corporation held a residual interest in a REMIC, see instructions			7
8	**Exemption phase-out** (if line 7 is $310,000 or more, skip lines 8a and 8b and enter -0- on line 8c):			
a	Subtract $150,000 from line 7 (if completing this line for a member of a controlled group, see instructions). If zero or less, enter -0-	8a		
b	Multiply line 8a by 25% (.25)	8b		
c	Exemption. Subtract line 8b from $40,000 (if completing this line for a member of a controlled group, see instructions). If zero or less, enter -0-			8c
9	Subtract line 8c from line 7. If zero or less, enter -0-			9
10	If the corporation had qualified timber gain, complete Part II and enter the amount from line 24 here. Otherwise, multiply line 9 by 20% (.20)			10
11	Alternative minimum tax foreign tax credit (AMTFTC) (see instructions)			11
12	Tentative minimum tax. Subtract line 11 from line 10			12
13	Regular tax liability before applying all credits except the foreign tax credit			13
14	**Alternative minimum tax.** Subtract line 13 from line 12. If zero or less, enter -0-. Enter here and on Form 1120, Schedule J, line 3, or the appropriate line of the corporation's income tax return			14

Form **4797**

Department of the Treasury
Internal Revenue Service (99)

Sales of Business Property

(Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2))

▶ Attach to your tax return. ▶ See separate instructions.

OMB No. 1545-0184

2009

Attachment Sequence No. **27**

Name(s) shown on return | Identifying number

1	Enter the gross proceeds from sales or exchanges reported to you for 2009 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20 (see instructions)	1	

Part I **Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other Than Casualty or Theft—Most Property Held More Than 1 Year** (see instructions)

2 (a) Description of property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition	(f) Cost or other basis, plus improvements and expense of sale	(g) Gain or (loss) Subtract (f) from the sum of (d) and (e)

3	Gain, if any, from Form 4684, line 43	3	
4	Section 1231 gain from installment sales from Form 6252, line 26 or 37	4	
5	Section 1231 gain or (loss) from like-kind exchanges from Form 8824	5	
6	Gain, if any, from line 32, from other than casualty or theft.	6	
7	Combine lines 2 through 6. Enter the gain or (loss) here and on the appropriate line as follows:	7	
	Partnerships (except electing large partnerships) and S corporations. Report the gain or (loss) following the instructions for Form 1065, Schedule K, line 10, or Form 1120S, Schedule K, line 9. Skip lines 8, 9, 11, and 12 below.		
	Individuals, partners, S corporation shareholders, and all others. If line 7 is zero or a loss, enter the amount from line 7 on line 11 below and skip lines 8 and 9. If line 7 is a gain and you did not have any prior year section 1231 losses, or they were recaptured in an earlier year, enter the gain from line 7 as a long-term capital gain on the Schedule D filed with your return and skip lines 8, 9, 11, and 12 below.		
8	Nonrecaptured net section 1231 losses from prior years (see instructions)	8	
9	Subtract line 8 from line 7. If zero or less, enter -0-. If line 9 is zero, enter the gain from line 7 on line 12 below. If line 9 is more than zero, enter the amount from line 8 on line 12 below and enter the gain from line 9 as a long-term capital gain on the Schedule D filed with your return (see instructions)	9	

Part II **Ordinary Gains and Losses** (see instructions)

10 Ordinary gains and losses not included on lines 11 through 16 (include property held 1 year or less):

11	Loss, if any, from line 7	11	( )
12	Gain, if any, from line 7 or amount from line 8, if applicable	12	
13	Gain, if any, from line 31	13	
14	Net gain or (loss) from Form 4684, lines 35 and 42a	14	
15	Ordinary gain from installment sales from Form 6252, line 25 or 36	15	
16	Ordinary gain or (loss) from like-kind exchanges from Form 8824.	16	
17	Combine lines 10 through 16	17	
18	For all except individual returns, enter the amount from line 17 on the appropriate line of your return and skip lines a and b below. For individual returns, complete lines a and b below:		
a	If the loss on line 11 includes a loss from Form 4684, line 39, column (b)(ii), enter that part of the loss here. Enter the part of the loss from income-producing property on Schedule A (Form 1040), line 28, and the part of the loss from property used as an employee on Schedule A (Form 1040), line 23. Identify as from "Form 4797, line 18a." See instructions	18a	
b	Redetermine the gain or (loss) on line 17 excluding the loss, if any, on line 18a. Enter here and on Form 1040, line 14	18b	

Form 4797 (2009) Page 2

Part III **Gain From Disposition of Property Under Sections 1245, 1250, 1252, 1254, and 1255** (see instructions)

19 (a) Description of section 1245, 1250, 1252, 1254, or 1255 property:	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)
A		
B		
C		
D		

These columns relate to the properties on lines 19A through 19D. ▶		Property A	Property B	Property C	Property D
20 Gross sales price (**Note:** *See line 1 before completing.*)	20				
21 Cost or other basis plus expense of sale	21				
22 Depreciation (or depletion) allowed or allowable	22				
23 Adjusted basis. Subtract line 22 from line 21	23				
24 Total gain. Subtract line 23 from line 20	24				
25 **If section 1245 property:**					
a Depreciation allowed or allowable from line 22	25a				
b Enter the **smaller** of line 24 or 25a	25b				
26 **If section 1250 property:** If straight line depreciation was used, enter -0- on line 26g, except for a corporation subject to section 291.					
a Additional depreciation after 1975 (see instructions)	26a				
b Applicable percentage multiplied by the **smaller** of line 24 or line 26a (see instructions)	26b				
c Subtract line 26a from line 24. If residential rental property **or** line 24 is not more than line 26a, skip lines 26d and 26e	26c				
d Additional depreciation after 1969 and before 1976	26d				
e Enter the **smaller** of line 26c or 26d	26e				
f Section 291 amount (corporations only)	26f				
g Add lines 26b, 26e, and 26f	26g				
27 **If section 1252 property:** Skip this section if you did not dispose of farmland or if this form is being completed for a partnership (other than an electing large partnership).					
a Soil, water, and land clearing expenses	27a				
b Line 27a multiplied by applicable percentage (see instructions)	27b				
c Enter the **smaller** of line 24 or 27b	27c				
28 **If section 1254 property:**					
a Intangible drilling and development costs, expenditures for development of mines and other natural deposits, mining exploration costs, and depletion (see instructions)	28a				
b Enter the **smaller** of line 24 or 28a	28b				
29 **If section 1255 property:**					
a Applicable percentage of payments excluded from income under section 126 (see instructions)	29a				
b Enter the **smaller** of line 24 or 29a (see instructions)	29b				

Summary of Part III Gains. Complete property columns A through D through line 29b before going to line 30.

30 Total gains for all properties. Add property columns A through D, line 24	30	
31 Add property columns A through D, lines 25b, 26g, 27c, 28b, and 29b. Enter here and on line 13	31	
32 Subtract line 31 from line 30. Enter the portion from casualty or theft on Form 4684, line 37. Enter the portion from other than casualty or theft on Form 4797, line 6	32	

Part IV **Recapture Amounts Under Sections 179 and 280F(b)(2) When Business Use Drops to 50% or Less** (see instructions)

		(a) Section 179	(b) Section 280F(b)(2)
33 Section 179 expense deduction or depreciation allowable in prior years	33		
34 Recomputed depreciation (see instructions)	34		
35 Recapture amount. Subtract line 34 from line 33. See the instructions for where to report	35		

Form **6251**

Department of the Treasury
Internal Revenue Service (99)

Alternative Minimum Tax—Individuals

▶ See separate instructions.

▶ Attach to Form 1040 or Form 1040NR.

OMB No. 1545-0074

2009

Attachment Sequence No. **32**

Name(s) shown on Form 1040 or Form 1040NR | Your social security number

Part I Alternative Minimum Taxable Income (See instructions for how to complete each line.)

1	If filing Schedule A (Form 1040), enter the amount from Form 1040, line 41 (minus any amount on Form 8914, line 6), and go to line 2. Otherwise, enter the amount from Form 1040, line 38 (minus any amount on Form 8914, line 6), and go to line 7. (If less than zero, enter as a negative amount.)	1	
2	Medical and dental. Enter the **smaller** of Schedule A (Form 1040), line 4, **or** 2.5% (.025) of Form 1040, line 38. If zero or less, enter -0-	2	
3	Taxes from Schedule A (Form 1040), lines 5, 6, and 8	3	
4	Enter the home mortgage interest adjustment, if any, from line 6 of the worksheet on page 2 of the instructions	4	
5	Miscellaneous deductions from Schedule A (Form 1040), line 27	5	
6	If Form 1040, line 38, is over $166,800 (over $83,400 if married filing separately), enter the amount from line 11 of the **Itemized Deductions Worksheet** on page A-11 of the instructions for Schedule A (Form 1040)	6	( )
7	If filing Schedule L (Form 1040A or 1040), enter as a negative amount the sum of lines 6 and 20 from that schedule	7	( )
8	Tax refund from Form 1040, line 10 or line 21	8	( )
9	Investment interest expense (difference between regular tax and AMT)	9	
10	Depletion (difference between regular tax and AMT)	10	
11	Net operating loss deduction from Form 1040, line 21. Enter as a positive amount	11	
12	Alternative tax net operating loss deduction	12	( )
13	Interest from specified private activity bonds exempt from the regular tax	13	
14	Qualified small business stock (7% of gain excluded under section 1202)	14	
15	Exercise of incentive stock options (excess of AMT income over regular tax income)	15	
16	Estates and trusts (amount from Schedule K-1 (Form 1041), box 12, code A)	16	
17	Electing large partnerships (amount from Schedule K-1 (Form 1065-B), box 6)	17	
18	Disposition of property (difference between AMT and regular tax gain or loss)	18	
19	Depreciation on assets placed in service after 1986 (difference between regular tax and AMT)	19	
20	Passive activities (difference between AMT and regular tax income or loss)	20	
21	Loss limitations (difference between AMT and regular tax income or loss)	21	
22	Circulation costs (difference between regular tax and AMT)	22	
23	Long-term contracts (difference between AMT and regular tax income)	23	
24	Mining costs (difference between regular tax and AMT)	24	
25	Research and experimental costs (difference between regular tax and AMT)	25	
26	Income from certain installment sales before January 1, 1987	26	( )
27	Intangible drilling costs preference	27	
28	Other adjustments, including income-based related adjustments	28	
29	**Alternative minimum taxable income.** Combine lines 1 through 28. (If married filing separately and line 29 is more than $216,900, see page 8 of the instructions.)	29	

Part II Alternative Minimum Tax (AMT)

30 Exemption. (If you were under age 24 at the end of 2009, see page 8 of the instructions.)

IF your filing status is . . .	AND line 29 is not over . . .	THEN enter on line 30 . . .
Single or head of household	$112,500.	$46,700
Married filing jointly or qualifying widow(er)	150,000	70,950
Married filing separately	75,000	35,475

30

If line 29 is **over** the amount shown above for your filing status, see page 8 of the instructions.

31	Subtract line 30 from line 29. If more than zero, go to line 32. If zero or less, enter -0- here and on lines 34 and 36 and skip the rest of Part II.	31	
32	• If you are filing Form 2555 or 2555-EZ, see page 9 of the instructions for the amount to enter. • If you reported capital gain distributions directly on Form 1040, line 13; you reported qualified dividends on Form 1040, line 9b; **or** you had a gain on both lines 15 and 16 of Schedule D (Form 1040) (as refigured for the AMT, if necessary), complete Part III on the back and enter the amount from line 55 here. • **All others:** If line 31 is $175,000 or less ($87,500 or less if married filing separately), multiply line 31 by 26% (.26). Otherwise, multiply line 31 by 28% (.28) and subtract $3,500 ($1,750 if married filing separately) from the result.	32	
33	Alternative minimum tax foreign tax credit (see page 9 of the instructions)	33	
34	Tentative minimum tax. Subtract line 33 from line 32	34	
35	Tax from Form 1040, line 44 (minus any tax from Form 4972 and any foreign tax credit from Form 1040, line 47). If you used Schedule J to figure your tax, the amount from line 44 of Form 1040 must be refigured without using Schedule J (see page 11 of the instructions)	35	
36	**AMT.** Subtract line 35 from line 34. If zero or less, enter -0-. Enter here and on Form 1040, line 45	36	

Part III Tax Computation Using Maximum Capital Gains Rates

37	Enter the amount from Form 6251, line 31. If you are filing Form 2555 or 2555-EZ, enter the amount from line 3 of the worksheet on page 9 of the instructions		37	
38	Enter the amount from line 6 of the Qualified Dividends and Capital Gain Tax Worksheet in the instructions for Form 1040, line 44, or the amount from line 13 of the Schedule D Tax Worksheet on page D-10 of the instructions for Schedule D (Form 1040), whichever applies (as refigured for the AMT, if necessary) (see page 11 of the instructions). If you are filing Form 2555 or 2555-EZ, see page 11 of the instructions for the amount to enter	38		
39	Enter the amount from Schedule D (Form 1040), line 19 (as refigured for the AMT, if necessary) (see page 11 of the instructions). If you are filing Form 2555 or 2555-EZ, see page 11 of the instructions for the amount to enter	39		
40	If you did not complete a Schedule D Tax Worksheet for the regular tax or the AMT, enter the amount from line 38. Otherwise, add lines 38 and 39, and enter the **smaller** of that result or the amount from line 10 of the Schedule D Tax Worksheet (as refigured for the AMT, if necessary). If you are filing Form 2555 or 2555-EZ, see page 11 of the instructions for the amount to enter	40		
41	Enter the **smaller** of line 37 or line 40		41	
42	Subtract line 41 from line 37		42	
43	If line 42 is $175,000 or less ($87,500 or less if married filing separately), multiply line 42 by 26% (.26). Otherwise, multiply line 42 by 28% (.28) and subtract $3,500 ($1,750 if married filing separately) from the result ▶		43	
44	Enter: • $67,900 if married filing jointly or qualifying widow(er), • $33,950 if single or married filing separately, or • $45,500 if head of household.	44		
45	Enter the amount from line 7 of the Qualified Dividends and Capital Gain Tax Worksheet in the instructions for Form 1040, line 44, or the amount from line 14 of the Schedule D Tax Worksheet on page D-10 of the instructions for Schedule D (Form 1040), whichever applies (as figured for the regular tax). If you did not complete either worksheet for the regular tax, enter -0-	45		
46	Subtract line 45 from line 44. If zero or less, enter -0-	46		
47	Enter the **smaller** of line 37 or line 38	47		
48	Enter the **smaller** of line 46 or line 47	48		
49	Subtract line 48 from line 47	49		
50	Multiply line 49 by 15% (.15) ▶		50	
	If line 39 is zero or blank, skip lines 51 and 52 and go to line 53. Otherwise, go to line 51.			
51	Subtract line 47 from line 41	51		
52	Multiply line 51 by 25% (.25) ▶		52	
53	Add lines 43, 50, and 52		53	
54	If line 37 is $175,000 or less ($87,500 or less if married filing separately), multiply line 37 by 26% (.26). Otherwise, multiply line 37 by 28% (.28) and subtract $3,500 ($1,750 if married filing separately) from the result		54	
55	Enter the **smaller** of line 53 or line 54 here and on line 32. If you are filing Form 2555 or 2555-EZ, do not enter this amount on line 32. Instead, enter it on line 4 of the worksheet on page 9 of the instructions.		55	

Appendix C

GLOSSARY

The key terms in this glossary have been defined to reflect their conventional use in the field of taxation. The definitions may therefore be incomplete for other purposes.

A

Accelerated cost recovery system (ACRS). A method in which the cost of tangible property is recovered over a prescribed period of time. The approach disregards salvage value, imposes a period of cost recovery that depends upon the classification of the asset into one of various recovery periods, and prescribes the applicable percentage of cost that can be deducted each year. § 168.

Accident and health insurance benefits. Employee fringe benefits provided by employers through the payment of health and accident insurance premiums or the establishment of employer-funded medical reimbursement plans. Employers generally are entitled to a deduction for such payments, whereas employees generally exclude such fringe benefits from gross income. §§ 105 and 106.

Accountable plan. An accountable plan is a type of expense reimbursement plan that requires an employee to render an adequate accounting to the employer and return any excess reimbursement or allowance. If the expense qualifies, it will be treated as a deduction *for* AGI.

Accounting income. The accountant's concept of income is generally based upon the realization principle. Financial accounting income may differ from taxable income (e.g., accelerated depreciation might be used for Federal income tax and straight-line depreciation for financial accounting purposes). Differences are included in a reconciliation of taxable and accounting income on Schedule M–1 or Schedule M–3 of Form 1120 for corporations.

Accounting method. The method under which income and expenses are determined for tax purposes. Important accounting methods include the cash basis and the accrual basis. Special methods are available for the reporting of gain on installment sales, recognition of income on construction projects (the completed contract and percentage of completion methods), and the valuation of inventories (last-in, first-out and first-in, first-out). §§ 446–474.

Accounting period. The period of time, usually a year, used by a taxpayer for the determination of tax liability. Unless a fiscal year is chosen, taxpayers must determine and pay their income tax liability by using the calendar year (January 1 through December 31) as the period of measurement. An example of a fiscal year is July 1 through June 30. A change in accounting period (e.g., from a calendar year to a fiscal year) generally requires the consent of the IRS. Some new taxpayers, such as a newly formed corporation, are free to select either an initial calendar or a fiscal year without the consent of the IRS. §§ 441–444.

Accrual method. A method of accounting that reflects expenses incurred and income earned for any one tax year. In contrast to the cash basis of accounting, expenses need not be paid to be deductible, nor need income be received to be taxable. Unearned income (e.g., prepaid interest and rent) generally is taxed in the year of receipt regardless of the method of accounting used by the taxpayer. § 446(c)(2).

Accumulated adjustments account (AAA). An account that aggregates an S corporation's post-1982 income, loss, and deductions for the tax year (including nontaxable income and nondeductible losses and expenses). After the year-end income and expense adjustments are made, the account is reduced by distributions made during the tax year. § 1368(e)(1).

Accumulated earnings and profits. Net undistributed tax-basis earnings of a corporation aggregated from March 1, 1913, to the end of the prior tax year. Used to determine the amount of dividend income associated with a distribution to shareholders. § 316 and Reg. § 1.316–2.

Acquiescence. Agreement by the IRS on the results reached in certain judicial decisions; sometimes abbreviated *Acq.* or *A.*

Acquisition indebtedness. Debt incurred in acquiring, constructing, or substantially improving a qualified residence of the taxpayer. The interest on such loans is deductible as qualified residence interest. However, interest on such debt is deductible only on the portion of the indebtedness that does not exceed $1,000,000 ($500,000 for married persons filing separate returns). § 163(h)(3).

Active income. Active income includes wages, salary, commissions, bonuses, profits from a trade or business in which the taxpayer is a material participant, gain on the sale or other disposition of assets used in an active trade or business, and

income from intangible property if the taxpayer's personal efforts significantly contributed to the creation of the property. The passive activity loss rules require classification of income and losses into three categories with active income being one of them. § 465.

Ad valorem tax. A tax imposed on the value of property. The most common ad valorem tax is that imposed by states, counties, and cities on real estate. Ad valorem taxes can be imposed on personal property as well.

Additional depreciation. The excess of the amount of depreciation actually deducted over the amount that would have been deducted had the straight-line method been used. § 1250(b).

Adjusted basis. The cost or other basis of property reduced by depreciation allowed or allowable and increased by capital improvements. Other special adjustments are provided in § 1016 and the related Regulations.

Adjusted current earnings (ACE). An adjustment in computing corporate alternative minimum taxable income (AMTI), computed at 75 percent of the excess of adjusted current earnings (ACE) over unadjusted AMTI. ACE computations reflect longer and slower cost recovery deductions and other restrictions on the timing of certain recognition events. Exempt interest, life insurance proceeds, and other receipts that are included in earnings and profits but not in taxable income also increase the ACE adjustment. If unadjusted AMTI exceeds ACE, the ACE adjustment is negative. The negative adjustment is limited to the aggregate of the positive adjustments under ACE for prior years, reduced by any previously claimed negative adjustments. § 56(g).

Adoption expenses credit. A provision intended to assist taxpayers who incur nonrecurring costs directly associated with the adoption process such as legal costs, social service review costs, and transportation costs. Up to $12,170 ($12,170 for a child with special needs regardless of the actual adoption expenses) of costs incurred to adopt an eligible child qualify for the credit. A taxpayer may claim the credit in the year qualifying expenses are paid or incurred if the expenses are paid during or after the year in which the adoption is finalized. For qualifying expenses paid or incurred in a tax year prior to the year the adoption is finalized, the credit must be claimed in the tax year following the tax year during which the expenses are paid or incurred. § 23.

Alimony and separate maintenance payments. Alimony deductions result from the payment of a legal obligation arising from the termination of a marital relationship. Payments designated as alimony generally are included in the gross income of the recipient and are deductible *for* AGI by the payer. §§ 62(a)(10), 71, and 215.

Allocate. The assignment of income for various tax purposes. A multistate corporation's nonbusiness income usually is allocated to the state where the nonbusiness assets are located; it is not apportioned with the rest of the entity's income. International taxpayers allocate certain expenses in computing the taxable income from specific activities. Partnerships can allocate specific items of income, deduction, and credit if certain requirements are met.

Alternative depreciation system (ADS). A cost recovery system that produces a smaller deduction than would be calculated under ACRS or MACRS. The alternative system must be used in certain instances and can be elected in other instances. § 168(g).

Alternative minimum tax (AMT). The AMT is a fixed percentage of alternative minimum taxable income (AMTI). AMTI generally starts with the taxpayer's adjusted gross income (for individuals) or taxable income (for other taxpayers). To this amount, the taxpayer (1) adds designated preference items (e.g., tax-exempt interest income on private activity bonds), (2) makes other specified adjustments (e.g., to reflect a longer, straight-line cost recovery deduction), (3) subtracts certain AMT itemized deductions for individuals (e.g., interest incurred on housing but not taxes paid), and (4) subtracts an exemption amount (e.g., $40,000 on a C corporation's return). The taxpayer must pay the greater of the resulting AMT (reduced by only the foreign tax credit) or the regular income tax (reduced by all allowable tax credits). The AMT does not apply to certain small C corporations. AMT preferences and adjustments are assigned to partners and S corporation shareholders. § 55–59.

Alternative minimum taxable income (AMTI). The base (prior to deducting the exemption amount) for computing a taxpayer's alternative minimum tax. This consists of the taxable income for the year modified for AMT adjustments and AMT preferences. § 55(b)(2).

American Opportunity credit. This credit replaces the HOPE scholarship credit for 2009 and 2010 and applies for qualifying expenses for the first four years of postsecondary education. Qualified expenses include tuition and related expenses and books and other course materials. Room and board are ineligible for the credit. The maximum credit available per student is $2,500 (100 percent of the first $2,000 of qualified expenses and 25 percent of the next $2,000 of qualified expenses). Eligible students include the taxpayer, taxpayer's spouse, and taxpayer's dependents. To qualify for the credit, a student must take at least one-half the full-time course load for at least one academic term at a qualifying educational institution. The credit is phased out for higher income taxpayers. §25A. See also *HOPE scholarship credit* and *lifetime learning credit.*

Amortization. The tax deduction for the cost or other basis of an intangible asset over the asset's estimated useful life. Examples of amortizable intangibles include patents, copyrights, and leasehold interests. The intangible goodwill can be amortized for income tax purposes over a 15-year period. § 197.

Amount realized. The amount received by a taxpayer upon the sale or exchange of property. Amount realized is the sum of the cash and the fair market value of any property or services received by the taxpayer, plus any related debt assumed by the buyer. Determining the amount realized is the starting point for arriving at realized gain or loss. § 1001(b).

Apportion. The assignment of the business income of a multistate corporation to specific states for income taxation. Usually, the apportionment procedure accounts for the property, payroll, and sales activity levels of the various states, and a proportionate assignment of the entity's total income is made, using a three-factor apportionment formula. Some states exclude nonbusiness income from the apportionment procedure; they allocate nonbusiness income to the states where the nonbusiness assets are located.

Arm's length concept. The standard under which unrelated parties would carry out a transaction. Suppose Bint Corporation sells property to its sole shareholder for $10,000. In determining whether $10,000 is an arm's length price, one

would ascertain the amount for which the corporation could have sold the property to a disinterested third party.

Arm's length price. See *arm's length concept.*

ASC 450 (SFAS 5). Under *Generally Accepted Accounting Principles,* the rules for the financial reporting of contingent liabilities, including deferred taxes.

ASC 740 (SFAS 109). Under *Generally Accepted Accounting Principles,* the rules for the financial reporting of the tax expense of an enterprise. *Permanent differences* affect the enterprise's effective tax rate. *Temporary differences* create a *deferred tax asset* or a *deferred tax liability* on the balance sheet.

ASC 740-10 (FIN 48). Under *Generally Accepted Accounting Principles,* an interpretation of *ASC 740* (*SFAS 109*) relating to when a tax benefit should be reported in an enterprise's financial statements. A tax benefit should be recorded for book purposes only if it is more likely than not that the taxpayer's filing position will be sustained after an audit, administrative appeal, and the highest applicable judicial review.

ASC 740-30 (APB 23). Under *Generally Accepted Accounting Principles,* the rules for the financial reporting of the tax expense relative to a U.S. corporation's non-U.S. subsidiary. If the parent documents that it is *permanently reinvesting* the non-U.S. earning of a non-U.S. subsidiary, the parent does not record as an expense any U.S. income tax that the parent might pay on such earnings, i.e., the book tax expense is deferred until such earnings are (if ever) repatriated to the United States.

Assignment of income. A procedure whereby a taxpayer attempts to avoid the recognition of income by assigning to another the property that generates the income. Such a procedure will not avoid the recognition of income by the taxpayer making the assignment if it can be said that the income was earned at the point of the transfer. In this case, usually referred to as an anticipatory assignment of income, the income will be taxed to the person who earns it.

Assumption of liabilities. In a corporate formation, corporate takeover, or asset purchase, the new owner often takes assets and agrees to assume preexisting debt. Such actions do not create boot received on the transaction for the new shareholder, unless there is no *bona fide* business purpose for the exchange, or the principal purpose of the debt assumption is the avoidance of tax liabilities. Gain is recognized to the extent that liabilities assumed exceed the aggregated bases of the transferred assets. § 357.

At-risk limitation. Generally, a taxpayer can deduct losses related to a trade or business, S corporation, partnership, or investment asset only to the extent of the at-risk amount.

Automatic mileage method. Automobile expenses are generally deductible only to the extent the automobile is used in business or for the production of income. Personal commuting expenses are not deductible. The taxpayer may deduct actual expenses (including depreciation and insurance), or the standard (automatic) mileage rate may be used (50 cents for 2010 and 55 cents for 2009). Automobile expenses incurred for medical purposes or in connection with job-related moving expenses are deductible to the extent of actual out-of-pocket expenses or at the rate of 16.5 cents per mile in 2010 (24 cents per mile for 2009). For charitable activities, the rate is 14 cents per mile.

B

Bad debts. A deduction is permitted if a business account receivable subsequently becomes partially or completely worthless, providing the income arising from the debt previously was included in income. Available methods are the specific charge-off method and the reserve method. However, except for certain financial institutions, TRA of 1986 repealed the use of the reserve method for 1987 and thereafter. If the reserve method is used, partially or totally worthless accounts are charged to the reserve. A nonbusiness bad debt deduction is allowed as a short-term capital loss if the loan did not arise in connection with the creditor's trade or business activities. Loans between related parties (family members) generally are classified as nonbusiness. § 166.

Balance sheet approach. The process under *ASC 740* (*SFAS 109*) by which an entity's *deferred tax expense* or *deferred tax benefit* is determined as a result of the reporting period's changes in the balance sheet's *deferred tax asset* and *deferred tax liability* accounts.

Basis in partnership interest. The acquisition cost of the partner's ownership interest in the partnership. Includes purchase price and associated debt acquired from other partners and in the course of the entity's trade or business. § 705.

Benchmarking. The tax professional's use of two or more entities' effective tax rates and deferred tax balance sheet accounts. Used chiefly to compare the effectiveness of the entities' tax planning techniques and to suggest future tax-motivated courses of action.

Boot. Cash or property of a type not included in the definition of a nontaxable exchange. The receipt of boot causes an otherwise nontaxable transfer to become taxable to the extent of the lesser of the fair market value of the boot or the realized gain on the transfer. For example, see transfers to controlled corporations under § 351(b) and like-kind exchanges under § 1031(b).

Brother-sister controlled group. More than one corporation owned by the same shareholders. If, for example, Chris and Pat each own one-half of the stock in Wren Corporation and Redbird Corporation, Wren and Redbird form a brother-sister controlled group. § 1563(a)(2).

Built-in gains tax. A penalty tax designed to discourage a shift of the incidence of taxation on unrealized gains from a C corporation to its shareholders, via an S election. Under this provision, any recognized gain during the first 10 years of S status generates a corporate-level tax on a base not to exceed the aggregate untaxed built-in gains brought into the S corporation upon its election from C corporation taxable years. § 1374.

Business bad debt. A tax deduction allowed for obligations obtained in connection with a trade or business that have become either partially or completely worthless. In contrast to nonbusiness bad debts, business bad debts are deductible as business expenses. § 166.

Buy-sell agreement. An arrangement, particularly appropriate in the case of a closely held corporation or a partnership, whereby the surviving owners (shareholders or partners) or the entity agrees to purchase the interest of a withdrawing owner. The buy-sell agreement provides for an orderly disposition of an interest in a business and may aid in setting the value of the interest for estate tax purposes.

C

C corporation. A separate taxable entity, subject to the rules of Subchapter C of the Code. This business form may create a double taxation effect relative to its shareholders. The entity is subject to the regular corporate tax and a number of penalty taxes at the Federal level.

Cafeteria plan. An employee benefit plan under which an employee is allowed to select from among a variety of employer-provided fringe benefits. Some of the benefits may be taxable, and some may be statutory nontaxable benefits (e.g., health and accident insurance and group term life insurance). The employee is taxed only on the taxable benefits selected. A cafeteria benefit plan is also referred to as a flexible benefit plan. § 125.

Capital account. The financial accounting analog of a partner's tax basis in the entity.

Capital asset. Broadly speaking, all assets are capital except those specifically excluded by the Code. Major categories of noncapital assets include property held for resale in the normal course of business (inventory), trade accounts and notes receivable, and depreciable property and real estate used in a trade or business (§ 1231 assets). § 1221.

Capital contribution. Various means by which a shareholder makes additional funds available to the corporation (placed at the risk of the business), sometimes without the receipt of additional stock. If no stock is received, the contributions are added to the basis of the shareholder's existing stock investment and do not generate gross income to the corporation. § 118.

Capital gain. The gain from the sale or exchange of a capital asset.

Capital gain property. Property contributed to a charitable organization that, if sold rather than contributed, would have resulted in long-term capital gain to the donor.

Capital interest. Usually, the percentage of the entity's net assets that a partner would receive on liquidation. Typically determined by the partner's capital sharing ratio.

Capital loss. The loss from the sale or exchange of a capital asset.

Capital sharing ratio. A partner's percentage ownership of the entity's capital.

Cash receipts method. A method of accounting that reflects deductions as paid and income as received in any one tax year. However, deductions for prepaid expenses that benefit more than one tax year (e.g., prepaid rent and prepaid interest) usually must be spread over the period benefited rather than deducted in the year paid. For fixed assets, the cash basis taxpayer claims deductions through depreciation or amortization in the same manner as an accrual basis taxpayer. § 446(c)(1).

Casualty loss. A casualty is defined as "the complete or partial destruction of property resulting from an identifiable event of a sudden, unexpected or unusual nature" (e.g., floods, storms, fires, auto accidents). Individuals may deduct a casualty loss only if the loss is incurred in a trade or business or in a transaction entered into for profit or arises from fire, storm, shipwreck, or other casualty or from theft. Individuals usually deduct personal casualty losses as itemized deductions subject to a $100 ($500 for 2009) nondeductible amount and to an annual floor equal to 10 percent of adjusted gross income that applies after the $100 ($500 for 2009) per casualty floor has been applied. Special rules are provided for the netting of certain casualty gains and losses. § 165(c)(3).

Charitable contributions. Contributions are deductible (subject to various restrictions and ceiling limitations) if made to qualified nonprofit charitable organizations. A cash basis taxpayer is entitled to a deduction solely in the year of payment. Accrual basis corporations may accrue contributions at year-end if payment is properly authorized before the end of the year and payment is made within two and one-half months after the end of the year. § 170.

Check-the-box Regulation. A business entity can elect to be taxed as a partnership, S corporation, or C corporation by indicating its preference on the tax return. Legal structure and operations are irrelevant in this regard. Thus, by using the check-the-box rules prudently, an entity can select the most attractive tax results offered by the Code, without being bound by legal forms. Not available if the entity is incorporated under state law.

Child tax credit. A tax credit based solely on the number of qualifying children under age 17. The maximum credit available is $1,000 per child through 2010. A qualifying child must be claimed as a dependent on a parent's tax return in order to qualify for the credit. Taxpayers who qualify for the child tax credit may also qualify for a supplemental credit. The supplemental credit is treated as a component of the earned income credit and is therefore refundable. The credit is phased out for higher-income taxpayers. § 24.

Circuit Court of Appeals. Any of 13 Federal courts that consider tax matters appealed from the U.S. Tax Court, a U.S. District Court, or the U.S. Court of Federal Claims. Appeal from a U.S. Court of Appeals is to the U.S. Supreme Court by *Certiorari.*

Citator. A tax research resource that presents the judicial history of a court case and traces the subsequent references to the case. When these references include the citing cases' evaluations of the cited case's precedents, the research can obtain some measure of the efficacy and reliability of the original holding.

Claim of right doctrine. A judicially imposed doctrine applicable to both cash and accrual basis taxpayers that holds that an amount is includible in income upon actual or constructive receipt if the taxpayer has an unrestricted claim to the payment. For the tax treatment of amounts repaid when previously included in income under the claim of right doctrine, see § 1341.

Closely held C corporation. A regular corporation (i.e., the S election is not in effect) for which more than 50 percent of the value of its outstanding stock is owned, directly or indirectly, by five or fewer individuals at any time during the tax year. The term is relevant in identifying C corporations that are subject to the passive activity loss provisions. § 469.

Collectibles. A special type of capital asset, the gain from which is taxed at a maximum rate of 28 percent if the holding period is more than one year. Examples include art, rugs, antiques, gems, metals, stamps, some coins and bullion, and alcoholic beverages held for investment. § 1(h).

Compensatory damages. Damages received or paid by the taxpayer can be classified as compensatory damages or as punitive damages. Compensatory damages are those paid to compensate one for harm caused by another.

Compensatory damages are excludible from the recipient's gross income. § 104(a)(2).

Conduit concept. An approach assumed by the tax law in the treatment of certain entities and their owners. Specific tax characteristics pass through the entity without losing their identity. For example, items of income and expense, capital gains and losses, tax credits, etc., realized by a partnership pass through the partnership (a conduit) and are subject to taxation at the partner level. Also, in an S corporation, certain items pass through and are reported on the returns of the shareholders.

Conservatism principle. The theory behind much of *Generally Accepted Accounting Principles,* under which assurance is provided that an entity's balance sheet assets are not overstated, nor liabilities understated. For instance, under *ASC 740* (*SFAS 109*), a *deferred tax asset* is not recorded until it is more likely than not that the future tax benefit will be realized.

Constructive dividend. A taxable benefit derived by a shareholder from his or her corporation that is not actually called a dividend. Examples include unreasonable compensation, excessive rent payments, bargain purchases of corporate property, and shareholder use of corporate property. Constructive dividends generally are found in closely held corporations.

Constructive receipt. If income is unqualifiedly available although not physically in the taxpayer's possession, it is subject to the income tax. An example is accrued interest on a savings account. Under the constructive receipt of income concept, the interest is taxed to a depositor in the year available, rather than the year actually withdrawn. The fact that the depositor uses the cash basis of accounting for tax purposes is irrelevant. See Reg. § 1.451–2.

Control. Holding a specified level of stock ownership in a corporation. For § 351, the new shareholder(s) must hold at least 80 percent of the total combined voting power of all voting classes of stock and at least 80 percent of the shares of all nonvoting classes. Other tax provisions require different levels of control to bring about desired effects, such as 50 or 100 percent.

Controlled foreign corporation (CFC). A non-U.S. corporation in which more than 50 percent of the total combined voting power of all classes of stock entitled to vote or the total value of the stock of the corporation is owned by "U.S. shareholders" on any day during the taxable year of the foreign corporation. For purposes of this definition, a U.S. shareholder is any U.S. person who owns, or is considered to own, 10 percent or more of the total combined voting power of all classes of voting stock of the foreign corporation. Stock owned directly, indirectly, and constructively is used in this measure. Certain Subpart F income of the CFC is taxed to the U.S. shareholders when it is earned, not when it is later repatriated.

Controlled group. A controlled group of corporations is required to share the lower-level corporate tax rates and various other tax benefits among the members of the group. A controlled group may be either a brother-sister or a parent-subsidiary group. §§ 1561 and 1563.

Cost depletion. Depletion that is calculated based on the adjusted basis of the asset. The adjusted basis is divided by the expected recoverable units to determine the depletion per unit. The depletion per unit is multiplied by the units sold during the tax year to calculate cost depletion. § 612.

Cost recovery system. The system that provides for the write-off of the cost of an asset under ACRS or MACRS. The cost recovery system replaced the depreciation system as the method of writing off the cost of an asset for most capitalized assets placed in service after 1980 (after 1986 for MACRS). § 168.

Court of Federal Claims. A trial court (court of original jurisdiction) that decides litigation involving Federal tax matters. Appeal from this court is to the Court of Appeals for the Federal Circuit.

Court of original jurisdiction. The Federal courts are divided into courts of original jurisdiction and appellate courts. A dispute between a taxpayer and the IRS is first considered by a court of original jurisdiction (i.e., a trial court). The four Federal courts of original jurisdiction are the U.S. Tax Court, U.S. District Court, the Court of Federal Claims, and the Small Cases Division of the U.S. Tax Court.

Coverdell Education Savings Account (CESA). A savings account established to pay for qualified education expenses (i.e., tuition, fees, books, supplies, related equipment, room and board if the student's course load is at least one-half of the full-time course load). The maximum annual contribution to the savings account of a beneficiary is $2,000. The maximum annual contribution is subject to phaseout beginning at $95,000 for single taxpayers and $190,000 for married couples who file a joint return. Contributions are not deductible and cannot be made to a savings account once the beneficiary attains age 18. Distributions used to pay for qualified education expenses for a designated beneficiary are tax-free. § 530.

Credit for child and dependent care expenses. A tax credit ranging from 20 percent to 35 percent of employment-related expenses (child and dependent care expenses) for amounts of up to $6,000 is available to individuals who are employed (or deemed to be employed) and maintain a household for a dependent child under age 13, disabled spouse, or disabled dependent. § 21.

Credit for employer-provided child care. A nonrefundable credit is available to employers who provided child care facilities to their employees during normal working hours. The credit, limited to $150,000, is comprised of two components. The portion of the credit for qualified child care expenses is equal to 25 percent of these expenses while the portion of the credit for qualified child care resources and referral services is equal to 10 percent of these expenses. Any qualifying expenses otherwise deductible by taxpayer must be reduced by the amount of the credit. In addition, the taxpayer's basis for any property used for qualifying purposes is reduced by the amount of the credit. § 45F.

Credit for small employer pension plan startup costs. A nonrefundable credit available to small businesses based on administrative costs associated with establishing and maintaining certain qualified plans. While such qualifying costs generally are deductible as ordinary and necessary business expense, the availability of the credit is intended to lower the costs of starting a qualified retirement program, and therefore encourage qualifying businesses to establish retirement plans for their employees. The credit is available for eligible employers at the rate of 50 percent of qualified startup costs. The maximum credit is $500 (based on a maximum of $1,000 of qualifying expenses). § 45E.

Current earnings and profits. Net tax-basis earnings of a corporation aggregated during the current tax year. A corporate

distribution is deemed to be first from the entity's current earnings and profits and then from accumulated earnings and profits. Shareholders recognize dividend income to the extent of the earnings and profits of the corporation. A dividend results to the extent of current earnings and profits, even if there is a larger negative balance in accumulated earnings and profits.

Current tax expense. Under *ASC 740 (SFAS 109)*, the book tax expense that relates to the current reporting period's net income and is actually payable (or creditable) to the appropriate governmental agencies for the current period. Also known as "cash tax" or "tax payable."

D

Deferred tax benefit. Under *ASC 740 (SFAS 109)*, a reduction in the book tax expense that relates to the current reporting period's net income but will not be realized until a future reporting period. Creates or adds to the entity's *deferred tax asset* balance sheet account. For instance, the carryforward of a *net operating loss* is a deferred tax benefit.

Deferred tax expense. Under *ASC 740 (SFAS 109)*, a book tax expense that relates to the current reporting period's net income but will not be realized until a future reporting period. Creates or adds to the entity's *deferred tax liability* balance sheet account. For instance, a deferred tax expense is created when tax depreciation deductions for the period are "accelerated" and exceed the corresponding book depreciation expense.

***De minimis* fringe benefits.** Benefits provided to employees that are too insignificant to warrant the time and effort required to account for the benefits received by each employee and the value of those benefits. Such amounts are excludible from the employee's gross income. § 132.

Death tax. See *estate tax.*

Deduction for qualified tuition and related expenses. Taxpayers are allowed a deduction of up to $4,000 for higher education expenses. Certain taxpayers are not eligible for the deduction: those whose AGI exceeds a specified amount and those who can be claimed as a dependent by another taxpayer. These expenses are classified as a deduction *for* AGI and they need not be employment related. § 222.

Deemed-paid credit. A foreign tax credit allowed to a U.S. taxpayer that has received an actual or constructive dividend from a non-U.S. corporation that has paid foreign income taxes. The credit is computed using the proportion of foreign income taxes paid by the payor corporation to its post-1986 undistributed earnings. Under § 78, the U.S. taxpayer claiming a deemed-paid credit includes the same amount in gross income for the tax year.

Dependency exemption. The tax law provides an exemption for each individual taxpayer and an additional exemption for the taxpayer's spouse if a joint return is filed. An individual may also claim a dependency exemption for each dependent, provided certain tests are met. The amount of the personal and dependency exemptions is $3,650 in 2010 ($3,650 in 2009). The exemption was subject to phaseout once adjusted gross income exceeded certain statutory threshold amounts. This phaseout provision was subject to partial phaseout beginning in 2006. For 2009, two-thirds of the reduction in the exemption amount is phased out and for 2010 all of the reduction is phased out. §§ 151 and 152.

Depletion. The process by which the cost or other basis of a natural resource (e.g., an oil or gas interest) is recovered upon extraction and sale of the resource. The two ways to determine the depletion allowance are the cost and percentage (or statutory) methods. Under cost depletion, each unit of production sold is assigned a portion of the cost or other basis of the interest. This is determined by dividing the cost or other basis by the total units expected to be recovered. Under percentage (or statutory) depletion, the tax law provides a special percentage factor for different types of minerals and other natural resources. This percentage is multiplied by the gross income from the interest to arrive at the depletion allowance. §§ 611–613 and 613A.

Depreciation rules. The depreciation system that existed prior to the enactment of the Accelerated Cost Recovery System (ACRS). This system applies to depreciable assets placed in service prior to January 1, 1981, and to certain post-1980 assets that do not qualify for ACRS. § 167.

Determination letter. Upon the request of a taxpayer, an IRS Area Director will comment on the tax status of a completed transaction. Determination letters frequently are used to clarify employee status, determine whether a retirement or profit sharing plan qualifies under the Code, and determine the tax-exempt status of certain nonprofit organizations.

Disabled access credit. A tax credit designed to encourage small businesses to make their facilities more accessible to disabled individuals. The credit is equal to 50 percent of the eligible expenditures that exceed $250 but do not exceed $10,250. Thus, the maximum amount for the credit is $5,000. The adjusted basis for depreciation is reduced by the amount of the credit. To qualify, the facility must have been placed in service before November 6, 1990. § 44.

Disaster area loss. A casualty sustained in an area designated as a disaster area by the President of the United States. In such an event, the disaster loss may be treated as having occurred in the taxable year immediately preceding the year in which the disaster actually occurred. Thus, immediate tax benefits are provided to victims of a disaster. § 165(i).

Disguised sale. When a partner contributes property to the entity and soon thereafter receives a distribution from the partnership, the transactions are collapsed, and the distribution is seen as a purchase of the asset by the partnership. § 707(a)(2)(B).

District Court. A Federal District Court is a trial court for purposes of litigating (among others) Federal tax matters. It is the only trial court where a jury trial can be obtained.

Dividend. A nondeductible distribution by a corporation to a shareholder. A dividend constitutes gross income to the recipient if it is from the current or accumulated earnings and profits of the corporation.

Dividends received deduction. A deduction allowed a shareholder that is a corporation for dividends received from a domestic corporation. The deduction usually is 70 percent of the dividends received, but it could be 80 or 100 percent depending upon the ownership percentage held by the recipient corporation. §§ 243–246.

Domestic production activities deduction (DPAD). See *production activities deduction (PAD).*

Domestic production gross receipts (DPGR). A key component in computing the domestic production activities deduction

(DPAD). Includes receipts from the sale and other disposition of qualified production property produced in significant part within the United States. DPGR is defined in § 199(c)(4). See also *production activities deduction (PAD).*

E

Earned income credit. A tax credit designed to provide assistance to certain low-income individuals who generally have a qualifying child. This is a refundable credit. To receive the most beneficial treatment, the taxpayer must have qualifying children. However, it is possible to qualify for the credit without having a child. To calculate the credit for a taxpayer with one or more children for 2010, a statutory rate of 34 percent for one child (40 percent for two children and 45 percent for three or more children) is multiplied by the earned income (subject to a statutory maximum of $8,970 with one qualifying child or $12,590 with two or more qualifying children). Once the earned income exceeds certain thresholds, the credit is phased out using a 15.98 percent rate for one qualifying child and a 21.06 percent rate for two or more qualifying children. For the qualifying taxpayer without children, the credit is calculated on a maximum earned income of $5,980 applying a 7.65 percent rate with the phaseout beginning later applying the same rate. § 32.

Earnings and profits (E & P). Measures the economic capacity of a corporation to make a distribution to shareholders that is not a return of capital. Such a distribution results in dividend income to the shareholders to the extent of the corporation's current and accumulated earnings and profits. §§ 312 and 316.

Economic effect test. Requirements that must be met before a special allocation may be used by a partnership. The premise behind the test is that each partner who receives an allocation of income or loss from a partnership bears the economic benefit or burden of the allocation.

Economic income. The change in the taxpayer's net worth, as measured in terms of market values, plus the value of the assets the taxpayer consumed during the year. Because of the impracticality of this income model, it is not used for tax purposes.

Education expenses. Employees may deduct education expenses that are incurred either (1) to maintain or improve existing job-related skills or (2) to meet the express requirements of the employer or the requirements imposed by law to retain employment status. The expenses are not deductible if the education is required to meet the minimum educational standards for the taxpayer's job or if the education qualifies the individual for a new trade or business. Reg. § 1.162–5.

Educational savings bonds. U.S. Series EE bonds whose proceeds are used for qualified higher educational expenses for the taxpayer, the taxpayer's spouse, or a dependent. The interest may be excluded from gross income, provided the taxpayer's adjusted gross income does not exceed certain amounts. § 135.

Effectively connected income. Income of a nonresident alien or non-U.S. corporation that is attributable to a trade or business operating in the United States. Income effectively connected to a U.S. trade or business usually is subject to U.S. income taxation, after deductions and allowing other credits, using the appropriate progressive tax rate schedule.

E-file. The electronic filing of a tax return. The filing is either direct or indirect. As to direct, the taxpayer goes online using a computer and tax return preparation software. Indirect filing occurs when a taxpayer utilizes an authorized IRS e-file provider. The provider often is the tax return preparer.

Employment taxes. Employment taxes are those taxes that an employer must pay on account of its employees. Employment taxes include FICA (Federal Insurance Contributions Act) and FUTA (Federal Unemployment Tax Act) taxes. Employment taxes are paid to the IRS in addition to income tax withholdings at specified intervals. Such taxes can be levied on the employees, the employer, or both. §§ 1401 and 1402.

Entertainment expenses. These expenses are deductible only if they are directly related to or associated with a trade or business. Various restrictions and documentation requirements have been imposed upon the deductibility of entertainment expenses to prevent abuses by taxpayers. See, for example, the provision contained in § 274(n) that disallows 50 percent of entertainment expenses. § 274.

Entity concept. The theory of partnership taxation under which a partnership is treated as a separate and distinct entity from the partners and has its own tax attributes.

Equity method. Under *Generally Accepted Accounting Principles*, the method of financial reporting for the operations of a subsidiary when the parent corporation owns between 20 and 50 percent of the subsidiary's stock. Creates a book-tax difference, as the two entities' operating results are combined for book purposes, but a Federal income tax *consolidated return* cannot be filed.

Estate tax. A tax imposed on the right to transfer property by death. Thus, an estate tax is levied on the decedent's estate and not on the heir receiving the property. §§ 2001–2058.

Estimated tax. The amount of tax (including alternative minimum tax and self-employment tax) a taxpayer expects to owe for the year after subtracting tax credits and income tax withheld. The estimated tax must be paid in installments at designated intervals (e.g., for the individual taxpayer, by April 15, June 15, September 15, and January 15 of the following year). § 6654.

Excise tax. A tax on the manufacture, sale, or use of goods; on the carrying on of an occupation or activity; or on the transfer of property. Thus, the Federal estate and gift taxes are, theoretically, excise taxes.

F

Fair market value. The amount at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of the relevant facts. Reg. §§ 1.1001–1(a) and 20.2031–1(b).

FDAP. Income of a nonresident alien or non-U.S. corporation that is received in the form of dividends, interest, rents, royalties, certain compensation, premiums, annuities, and other "fixed, determinable, annual, or periodic" forms. FDAP income usually is subject to U.S. income taxation at a flat 30 percent tax rate.

FICA tax. An abbreviation that stands for Federal Insurance Contributions Act, commonly referred to as the Social

Security tax. The FICA tax is comprised of the Social Security tax (old age, survivors, and disability insurance) and the Medicare tax (hospital insurance) and is imposed on both employers and employees. The employer is responsible for withholding from the employee's wages the Social Security tax at a rate of 6.2 percent on a maximum wage base of $106,800 (for 2010) and the Medicare tax at a rate of 1.45 percent (no maximum wage base). The employer is required to match the employee's contribution. § 3101.

Fifty percent additional first-year depreciation. This provision, which was effective for property acquired after December 31, 2007, and placed in service before January 1, 2009, provided for an additional cost recovery deduction of 50 percent in the tax year the qualified property was placed in service. Qualified property included most types of new property other than buildings. The taxpayer can elect to forgo this bonus depreciation. The American Recovery and Reinvestment Tax Act of 2009 extended the additional first-year depreciation provision for an additional year. See also *cost recovery system.*

Final Regulation. The U.S. Treasury Department Regulations (abbreviated Reg.) represent the position of the IRS as to how the Internal Revenue Code is to be interpreted. Their purpose is to provide taxpayers and IRS personnel with rules of general and specific application to the various provisions of the tax law. Regulations are published in the *Federal Register* and in all tax services.

Flexible spending plan. An employee benefit plan that allows the employee to take a reduction in salary in exchange for the employer paying benefits that can be provided by the employer without the employee being required to recognize income (e.g., medical and child care benefits).

Foreign earned income exclusion. The foreign earned income exclusion is a relief provision that applies to U.S. citizens working in a foreign country. To qualify for the exclusion, the taxpayer must be either a bona fide resident of the foreign country or present in the foreign country for 330 days during any 12 consecutive months. The exclusion is limited to $91,500 per year for 2010 ($91,400 in 2009). § 911.

Foreign tax credit. A U.S. citizen or resident who incurs or pays income taxes to a foreign country on income subject to U.S. tax may be able to claim some or all of these taxes as a credit against the U.S. income tax. §§ 27 and 901–905.

Franchise. An agreement that gives the transferee the right to distribute, sell, or provide goods, services, or facilities within a specified area. The cost of obtaining a franchise may be amortized over a statutory period of 15 years. In general, the franchisor's gain on the sale of franchise rights is an ordinary gain because the franchisor retains a significant power, right, or continuing interest in the subject of the franchise. §§ 197 and 1253.

Franchise tax. A tax levied on the right to do business in a state as a corporation. Although income considerations may come into play, the tax usually is based on the capitalization of the corporation.

Fruit and tree metaphor. The courts have held that an individual who earns income from property or services cannot assign that income to another. For example, a father cannot assign his earnings from commissions to his child and escape income tax on those amounts.

FUTA tax. An employment tax levied on employers. Jointly administered by the Federal and state governments, the tax provides funding for unemployment benefits. FUTA applies at a rate of 6.2 percent on the first $7,000 of covered wages paid during the year for each employee. The Federal government allows a credit for FUTA paid (or allowed under a merit rating system) to the state. The credit cannot exceed 5.4 percent of the covered wages. § 3301.

G

General business credit. The summation of various nonrefundable business credits, including the tax credit for rehabilitation expenditures, business energy credit, work opportunity credit, research activities credit, low-income housing credit, disabled access credit, credit for small employer pension plan startup costs, and credit for employer-provided child care. The amount of general business credit that can be used to reduce the tax liability is limited to the taxpayer's net income tax reduced by the greater of (1) the tentative minimum tax or (2) 25 percent of the net regular tax liability that exceeds $25,000. Unused general business credits can be carried back 1 year and forward 20 years. § 38.

General partnership. A partnership that is owned by one or more general partners. Creditors of a general partnership can collect amounts owed them from both the partnership assets and the assets of the partners individually.

Gift. A transfer of property for less than adequate consideration. Gifts usually occur in a personal setting (such as between members of the same family). They are excluded from the income tax base but may be subject to a transfer tax.

Gift tax. A tax imposed on the transfer of property by gift. The tax is imposed upon the donor of a gift and is based on the fair market value of the property on the date of the gift. §§ 2501–2524.

Goodwill. The reputation and built-up business of a company. For accounting purposes, goodwill has no basis unless it is purchased. In the purchase of a business, goodwill generally is the difference between the purchase price and the fair market value of the assets acquired. Since acquired goodwill is a § 197 intangible asset, it is amortized for tax purposes over a 15-year period. Reg. § 1.167(a)–3.

Gross income. Income subject to the Federal income tax. Gross income does not include all economic income. That is, certain exclusions are allowed (e.g., interest on municipal bonds). For a manufacturing or merchandising business, gross income usually means gross profit (gross sales or gross receipts less cost of goods sold). § 61 and Reg. § 1.61–3(a).

Guaranteed payments. Payments made by a partnership to a partner for services rendered or for the use of capital to the extent that the payments are determined without regard to the income of the partnership. The payments are treated as though they were made to a nonpartner and thus are usually deductible by the entity. § 707(c).

H

Half-year convention. The half-year convention is a cost recovery convention that assumes all property is placed in service at mid-year and thus provides for a half-year's cost recovery for that year.

Head of household. An unmarried individual who maintains a household for another and satisfies certain conditions set forth in § 2(b). This status enables the taxpayer to use a set of income tax rates that are lower than those applicable to other unmarried individuals but higher than those applicable to surviving spouses and married persons filing a joint return.

Health Savings Account (HSA). A medical savings account created in legislation enacted in December 2003 that is designed to replace and expand Archer Medical Savings Accounts. See also *medical savings account.*

Holding period. The period of time during which property has been held for income tax purposes. The holding period is significant in determining whether gain or loss from the sale or exchange of a capital asset is long term or short term. § 1223.

Home equity loans. Loans that utilize the personal residence of the taxpayer as security. The interest on such loans is deductible as qualified residence interest. However, interest is deductible only on the portion of the loan that does not exceed the lesser of (1) the fair market value of the residence, reduced by the acquisition indebtedness, or (2) $100,000 ($50,000 for married persons filing separate returns). A major benefit of a home equity loan is that there are no tracing rules regarding the use of the loan proceeds. § 163(h)(3).

HOPE scholarship credit. A tax credit for qualifying expenses paid for the first two years of postsecondary education. Room, board, and book costs are ineligible for the credit. The maximum credit available is $1,800 per year per student, computed as 100 percent of the first $1,200 of qualifying expenses, plus 50 percent of the second $1,200 of qualifying expenses. Eligible students include the taxpayer, taxpayer's spouse, and taxpayer's dependents. To qualify for the credit, a student must take at least one-half the full-time course load for at least one academic term at a qualifying educational institution. The credit is phased out for higher-income taxpayers. For 2009 and 2010, the HOPE scholarship credit is replaced with the American Opportunity credit. See also *American Opportunity credit* and *lifetime learning credit.* § 25A.

Hybrid method. A combination of the accrual and cash methods of accounting. That is, the taxpayer may account for some items of income on the accrual method (e.g., sales and cost of goods sold) and other items (e.g., interest income) on the cash method.

I

Implicit tax. A tax that is paid through higher prices or lower returns on tax-favored investments rather than being paid directly to the government (i.e., an explicit tax). The value added tax is an example of an implicit tax.

Inbound taxation. U.S. tax effects when a non-U.S. person undertakes an investment or business activity in the United States.

Income. For tax purposes, an increase in wealth that has been realized.

Income tax provision. Under *ASC 740* (*SFAS 109*), a synonym for the book tax expense of an entity for the financial reporting period. Following the "matching principle," all book tax expense that relates to the net income for the reporting period is reported on that period's financial statements, including not only the *current tax expense,* but also any *deferred tax expense* and *deferred tax benefit.*

Income tax treaties. An agreement between the U.S. State Department and another country designed to alleviate potential double taxation and to share administrative information useful to tax agencies in both countries, relative to taxpayers with investment or business activities in both countries.

Independent contractor. A self-employed person as distinguished from one who is employed as an employee.

Individual Retirement Account (IRA). A type of retirement plan to which an individual with earned income can contribute a maximum of $3,000 ($3,000 each in the case of a married couple with a spousal IRA) per tax year for 2002–2004. The maximum amount increases to $4,000 in 2005 and to $5,000 in 2008. The amount remains at $5,000 for 2009 and 2010. IRAs can be classified as traditional IRAs or Roth IRAs. With a traditional IRA, an individual can contribute and deduct a maximum of $5,000 per tax year in 2010. The deduction is a deduction *for* AGI. However, if the individual is an active participant in another qualified retirement plan, the deduction is phased out proportionally between certain AGI ranges (note that the phaseout limits the amount of the deduction and not the amount of the contribution). With a Roth IRA, an individual can contribute a maximum of $5,000 per tax year in 2010. No deduction is permitted. However, if a five-year holding period requirement is satisfied and if the distribution is a qualified distribution, the taxpayer can make tax-free withdrawals from a Roth IRA. The maximum annual contribution is phased out proportionally between certain AGI ranges. §§ 219 and 408A.

Inheritance tax. A tax imposed on the right to receive property from a decedent. Thus, theoretically, an inheritance tax is imposed on the heir. The Federal estate tax is imposed on the estate.

Inside basis. A partnership's basis in the assets it owns.

Intangible drilling and development costs (IDC). Taxpayers may elect to expense or capitalize (subject to amortization) intangible drilling and development costs. However, ordinary income recapture provisions apply to oil and gas properties on a sale or other disposition if the expense method is elected. §§ 263(c) and 1254(a).

Interpretive Regulation. A Regulation issued by the Treasury Department that purports to explain the meaning of a particular Code Section. An interpretive Regulation is given less deference than a legislative Regulation.

Investment interest. Payment for the use of funds used to acquire assets that produce investment income. The deduction for investment interest is limited to net investment income for the tax year.

Involuntary conversion. The loss or destruction of property through theft, casualty, or condemnation. Any gain realized on an involuntary conversion can, at the taxpayer's election, be deferred for Federal income tax purposes if the owner reinvests the proceeds within a prescribed period of time in property that is similar or related in service or use. § 1033.

Itemized deductions. Personal and employee expenditures allowed by the Code as deductions from adjusted gross income. Examples include certain medical expenses, interest on home mortgages, state income taxes, and charitable contributions. Itemized deductions are reported on Schedule A of Form 1040. Certain miscellaneous itemized deductions are reduced by 2 percent of the taxpayer's adjusted gross income. In addition, a taxpayer whose adjusted gross income exceeds a

certain level (indexed annually) must reduce the itemized deductions by 3 percent of the excess of adjusted gross income over that level. Medical, casualty and theft, and investment interest deductions are not subject to the 3 percent reduction. The 3 percent reduction may not reduce itemized deductions that are subject to the reduction to below 20 percent of their initial amount. Beginning in 2006, this reduction is subject to partial phaseout. For 2009, two-thirds of the reduction is phased out and for 2010 all of the reduction is phased out. §§ 63(d), 67, and 68.

K

Keogh plan. A retirement plan that is available to self-employed taxpayers; also referred to as an H.R. 10 plan. Under such plans, in 2010, a taxpayer may deduct each year up to either 100 percent of net earnings from self-employment or $49,000, whichever is less. If the plan is a profit sharing plan, the percentage is 25 percent.

Kiddie tax. Passive income, such as interest and dividends, that is recognized by a child under age 19 (under age 24 if a full-time student) is taxed to him or her at the rates that would have applied had the income been incurred by the child's parents, generally to the extent that the income exceeds $1,900. The additional tax is assessed regardless of the source of the income or the income's underlying property. If the child's parents are divorced, the custodial parent's rates are used. The parents' rates reflect any applicable alternative minimum tax and the phaseouts of lower tax brackets and other deductions. § 1(g).

L

Legislative Regulation. Some Code Sections give the Secretary of the Treasury or his delegate the authority to prescribe Regulations to carry out the details of administration or to otherwise complete the operating rules. Regulations issued pursuant to this type of authority truly possess the force and effect of law. In effect, Congress is almost delegating its legislative powers to the Treasury Department.

Lessee. One who rents property from another. In the case of real estate, the lessee is also known as the tenant.

Lessor. One who rents property to another. In the case of real estate, the lessor is also known as the landlord.

Letter ruling. The written response of the IRS to a taxpayer's request for interpretation of the revenue laws, with respect to a proposed transaction (e.g., concerning the tax-free status of a reorganization). Not to be relied on as precedent by other than the party who requested the ruling.

Life insurance proceeds. A specified sum (the face value or maturity value of the policy) paid to the designated beneficiary of the policy by the life insurance company upon the death of the insured.

Lifetime learning credit. A tax credit for qualifying expenses for taxpayers pursuing education beyond the first two years of postsecondary education. Individuals who are completing their last two years of undergraduate studies, pursuing graduate or professional degrees, or otherwise seeking new job skills or maintaining existing job skills are all eligible for the credit. Eligible individuals include the taxpayer, taxpayer's spouse, and taxpayer's dependents. The maximum credit is 20 percent of the first $10,000 of qualifying expenses and is computed per taxpayer. The credit is phased out for higher-income taxpayers. § 25A.

Like-kind exchange. An exchange of property held for productive use in a trade or business or for investment (except inventory and stocks and bonds) for other investment or trade or business property. Unless non-like-kind property (boot) is received, the exchange is fully nontaxable. § 1031.

Limited liability company (LLC). A form of entity allowed by all of the states. The entity is taxed as a partnership in which all members or owners of the LLC are treated much like limited partners. There are no restrictions on ownership, all members may participate in management, and none has personal liability for the entity's debts.

Limited liability partnership (LLP). A form of entity allowed by many of the states, where a general partnership registers with the state as an LLP. Owners are general partners, but a partner is not liable for any malpractice committed by other partners. The personal assets of the partners are at risk for the entity's contractual liabilities, such as accounts payable. The personal assets of a specific partner are at risk for his or her own professional malpractice and tort liability, and for malpractice and torts committed by those whom he or she supervises.

Limited partnership. A partnership in which some of the partners are limited partners. At least one of the partners in a limited partnership must be a general partner.

Listed property. The term listed property includes (1) any passenger automobile, (2) any other property used as a means of transportation, (3) any property of a type generally used for purposes of entertainment, recreation, or amusement, (4) any computer or peripheral equipment (with an exception for exclusive business use), (5) any cellular telephone (or other similar telecommunications equipment), and (6) any other property of a type specified in the Regulations. If listed property is predominantly used for business, the taxpayer is allowed to use the statutory percentage method of cost recovery. Otherwise, the straight-line cost recovery method must be used. § 280F.

Long-term nonpersonal-use capital assets. Includes investment property with a long-term holding period. Such property disposed of by casualty or theft may receive § 1231 treatment.

M

Marriage penalty. The additional tax liability that results for a married couple when compared with what their tax liability would be if they were not married and filed separate returns.

Material participation. If an individual taxpayer materially participates in a nonrental trade or business activity, any loss from that activity is treated as an active loss that can be offset against active income. Material participation is achieved by meeting any one of seven tests provided in the Regulations. § 469(h).

Medical expenses. Medical expenses of an individual, spouse, and dependents are allowed as an itemized deduction to the extent that such amounts (less insurance reimbursements) exceed 7.5 percent of adjusted gross income. § 213.

Medical savings account (MSA). A plan available to employees of small firms (50 or fewer employees) with high-deductible health insurance. The employee can place money in the fund and then deduct the contributions (within limits) from gross income. If the employer contributes to the fund, the employee can exclude the contribution from gross income. Income earned from the fund and withdrawals for medical care are not subject to tax. See also *Health Savings Account (HSA).* §§ 106(b) and 220.

Mid-month convention. A cost recovery convention that assumes property is placed in service in the middle of the month that it is actually placed in service.

Mid-quarter convention. A cost recovery convention that assumes property placed in service during the year is placed in service at the middle of the quarter in which it is actually placed in service. The mid-quarter convention applies if more than 40 percent of the value of property (other than eligible real estate) is placed in service during the last quarter of the year.

Minimum tax credit (AMT). When a corporation pays an alternative minimum tax (AMT), a minimum tax credit is created on a dollar-for-dollar basis, to be applied against regular tax liabilities incurred in future years. The credit is carried forward indefinitely, but it is not carried back. The effect of the credit for corporate taxpayers alternating between the AMT and regular tax models is to make the AMT liabilities a prepayment of regular taxes. Noncorporate AMT taxpayers are allowed the credit only with respect to the elements of the AMT that reflect timing differences between the two tax models. § 53.

Miscellaneous itemized deductions. A special category of itemized deductions that includes such expenses as professional dues, tax return preparation fees, job-hunting costs, unreimbursed employee business expenses, and certain investment expenses. Such expenses are deductible only to the extent they exceed 2 percent of adjusted gross income. § 67.

Modified accelerated cost recovery system (MACRS). A method in which the cost of tangible property is recovered over a prescribed period of time. Enacted by the Economic Recovery Tax Act (ERTA) of 1981 and substantially modified by the Tax Reform Act (TRA) of 1986 (the modified system is referred to as MACRS), the approach disregards salvage value, imposes a period of cost recovery that depends upon the classification of the asset into one of various recovery periods, and prescribes the applicable percentage of cost that can be deducted each year. § 168.

Modified adjusted gross income. A key determinant in computing the domestic production activities deduction (DPAD). The deduction is limited to a percentage of the *lesser of* qualified production activities income (QPAI) or modified adjusted gross income. Aside from limited changes required by § 199(d)(2)(A), modified adjusted gross income is AGI as usually determined but without any domestic production activities deduction (DPAD). See also *production activities deduction (PAD).*

Moving expenses. A deduction *for* AGI is permitted to employees and self-employed individuals provided certain tests are met. The taxpayer's new job must be at least 50 miles farther from the old residence than the old residence was from the former place of work. In addition, an employee must be employed on a full-time basis at the new location for 39 weeks in the 12-month period following the move. Deductible moving expenses include the cost of moving the household and personal effects, transportation, and lodging expenses during the move. The cost of meals during the move is not deductible. Qualified moving expenses that are paid (or reimbursed) by the employer can be excluded from the employee's gross income. In this case, the related deduction by the employee is not permitted. §§ 62(a)(15), 132(a)(6), and 217.

Multiple support agreement. To qualify for a dependency exemption, the support test must be satisfied. This requires that over 50 percent of the support of the potential dependent be provided by the taxpayer. Where no one person provides more than 50 percent of the support, a multiple support agreement enables a taxpayer to still qualify for the dependency exemption. Any person who contributed more than 10 percent of the support is entitled to claim the exemption if each person in the group who contributed more than 10 percent files a written consent (Form 2120). Each person who is a party to the multiple support agreement must meet all the other requirements for claiming the dependency exemption. § 152(c).

Multistate corporation. A corporation that has operations in more than one of the states of the United States. Issues arise relative to the assignment of appropriate amounts of the entity's taxable income to the states in which it has a presence. See also *allocate, apportion,* and *nexus.*

Multistate Tax Commission (MTC). A regulatory body of which about half of the U.S. states are members. The MTC develops operating rules and regulations to compute and assign the total taxable income of a multistate taxpayer to specific states.

N

Net capital gain. The excess of the net long-term capital gain for the tax year over the net short-term capital loss. The net capital gain of an individual taxpayer is eligible for the alternative tax. § 1222(11).

Net capital loss. The excess of the losses from sales or exchanges of capital assets over the gains from sales or exchanges of such assets. Up to $3,000 per year of the net capital loss may be deductible by noncorporate taxpayers against ordinary income. The excess net capital loss carries over to future tax years. For corporate taxpayers, the net capital loss cannot be offset against ordinary income, but it can be carried back three years and forward five years to offset net capital gains. §§ 1211, 1212, and 1221(10).

Net investment income. The excess of investment income over investment expenses. Investment expenses are those deductible expenses directly connected with the production of investment income. Investment expenses do not include investment interest. The deduction for investment interest for the tax year is limited to net investment income. § 163(d).

Net operating loss. To mitigate the effect of the annual accounting period concept, § 172 allows taxpayers to use an excess loss of one year as a deduction for certain past or future years. In this regard, a carryback period of 2 years and a carryforward period of 20 years currently are allowed.

Nexus. A multistate taxpayer's taxable income can be apportioned to a specific state only if the taxpayer has established a sufficient presence, or nexus with that state. State law,

which often follows the UDITPA, specifies various activities that lead to nexus in various states.

No-additional-cost services. Services that the employer may provide the employee at no additional cost to the employer. Generally, the benefit is the ability to utilize the employer's excess capacity (e.g., vacant seats on an airliner). Such amounts are excludible from the recipient's gross income. § 132(b).

Nonaccountable plan. An expense reimbursement plan that does not have an accountability feature. The result is that employee expenses must be claimed as deductions *from* AGI. An exception is moving expenses that are deductions *for* AGI.

Nonacquiescence. Disagreement by the IRS on the result reached in certain judicial decisions. *Nonacq.* or *NA.*

Nonbusiness bad debt. A bad debt loss that is not incurred in connection with a creditor's trade or business. The loss is classified as a short-term capital loss and is allowed only in the year the debt becomes entirely worthless. In addition to family loans, many investor losses are nonbusiness bad debts. § 166(d).

Nonrecourse debt. Debt secured by the property that it is used to purchase. The purchaser of the property is not personally liable for the debt upon default. Rather, the creditor's recourse is to repossess the related property. Nonrecourse debt generally does not increase the purchaser's at-risk amount.

Nonresident alien. An individual who is neither a citizen nor a resident of the United States. Citizenship is determined under the immigration and naturalization laws of the United States. Residency is determined under § 7701(b) of the Internal Revenue Code. Certain activities of the nonresident alien are subject to U.S. taxation.

Nontaxable exchange. A transaction in which realized gains or losses are not recognized. The recognition of gain or loss is postponed (deferred) until the property received in the nontaxable exchange is subsequently disposed of in a taxable transaction. Examples are § 1031 like-kind exchanges and § 1033 involuntary conversions.

O

Occupational tax. A tax imposed on various trades or businesses. A license fee that enables a taxpayer to engage in a particular occupation.

Office in the home expenses. Employment and business-related expenses attributable to the use of a residence (e.g., den or office) are allowed only if the portion of the residence is exclusively used on a regular basis as a principal place of business of the taxpayer or as a place of business that is used by patients, clients, or customers. If the expenses are incurred by an employee, the use must be for the convenience of the employer as opposed to being merely appropriate and helpful. § 280A.

Options. The sale or exchange of an option to buy or sell property results in capital gain or loss if the property is a capital asset. Generally, the closing of an option transaction results in short-term capital gain or loss to the writer of the call and the purchaser of the call option. § 1234.

Ordinary and necessary. An ordinary expense is one that is common and accepted in the general industry or type of activity in which the taxpayer is engaged. It comprises one of the tests for the deductibility of expenses incurred or paid in connection with a trade or business; for the production or collection of income; for the management, conservation, or maintenance of property held for the production of income; or in connection with the determination, collection, or refund of any tax. §§ 162(a) and 212. A necessary expense is one that is appropriate and helpful in furthering the taxpayer's business or income-producing activity. §§ 162(a) and 212.

Ordinary income property. Property contributed to a charitable organization that, if sold rather than contributed, would have resulted in other than long-term capital gain to the donor (i.e., ordinary income property and short-term capital gain property). Examples are inventory and capital assets held for less than the long-term holding period.

Organizational expenditures. Items incurred early in the life of a corporate entity, qualifying for a special treatment under Federal tax law. A corporation can elect to immediately expense the first $5,000 (subject to phaseout) of organizational expenditures and generally amortize the balance over a period of 180 months. Amortizable expenditures exclude those incurred to obtain capital (underwriting fees) or assets (subject to cost recovery). Typically, amortizable expenditures include legal and accounting fees and state incorporation payments. Such items must be incurred by the end of the entity's first tax year. § 248.

Original issue discount. The difference between the issue price of a debt obligation (e.g., a corporate bond) and the maturity value of the obligation when the issue price is *less than* the maturity value. OID represents interest and must be amortized over the life of the debt obligation using the effective interest method. The difference is not considered to be original issue discount for tax purposes when it is less than one-fourth of 1 percent of the redemption price at maturity multiplied by the number of years to maturity. §§ 1272 and 1273(a)(3).

Outbound taxation. U.S. tax effects when a U.S. person undertakes an investment or business activity outside the United States.

Outside basis. A partner's basis in his or her partnership interest.

P

Parent-subsidiary controlled group. A controlled or affiliated group of corporations, where at least one corporation is at least 80 percent owned by one or more of the others. The affiliated group definition is more difficult to meet.

Passive investment holding company. A means by which a multistate taxpayer can reduce its overall effective tax rate by isolating investment income in a no- or low-tax state.

Passive investment income (PII). Gross receipts from royalties, certain rents, dividends, interest, annuities, and gains from the sale or exchange of stock and securities. With certain exceptions, if the passive investment income of an S corporation exceeds 25 percent of the corporation's gross receipts for three consecutive years, S status is lost. In another circumstance, if the S corporation has excessive passive income, a penalty tax is imposed on the S corporation. §§ 1362(d)(3) and 1375.

Passive loss. Any loss from (1) activities in which the taxpayer does not materially participate or (2) rental activities (subject to certain exceptions). Net passive losses cannot be used to offset income from nonpassive sources. Rather, they are suspended until the taxpayer either generates net passive income (and a deduction of such losses is allowed) or disposes of the underlying property (at which time the loss deductions are allowed in full). One relief provision allows landlords who actively participate in the rental activities to deduct up to $25,000 of passive losses annually. However, a phaseout of the $25,000 amount commences when the landlord's AGI exceeds $100,000. Another relief provision applies for material participation in a real estate trade or business. § 469.

Patent. A patent is an intangible asset that may be amortized over a statutory 15-year period as a § 197 intangible. The sale of a patent usually results in favorable long-term capital gain treatment. §§ 197 and 1235.

Payroll factor. The proportion of a multistate corporation's total payroll that is traceable to a specific state. Used in determining the taxable income that is to be apportioned to that state.

Percentage depletion. Percentage depletion is depletion based on a statutory percentage applied to the gross income from the property. The taxpayer deducts the greater of cost depletion or percentage depletion. § 613.

Permanent differences. Under *ASC 740* (*SFAS 109*), tax-related items that appear in the entity's financial statements or its tax return, but not both. For instance, interest income from a municipal bond is a permanent book-tax difference.

Permanent establishment (PE). A level of business activity, as defined under an income tax treaty, that subjects the taxpayer to taxation in a country other than that in which the taxpayer is based. Often evidenced by the presence of a plant, office, or other fixed place of business. Inventory storage and temporary activities do not rise to the level of a PE. PE is the treaty's equivalent to nexus.

Permanently reinvesting. Under *ASC 740-30* (*APB 23*) of *Generally Accepted Accounting Principles*, a special rule that relates to the book tax expense of non-U.S. subsidiaries. If a parent corporation documents that it is *permanently reinvesting* the non-U.S. earnings of a non-U.S. subsidiary, the parent does not record as an expense any U.S. income tax that the parent might pay on such earnings, i.e., the book tax expense is deferred until such earnings are (if ever) repatriated to the United States.

Personal and dependency exemptions. The tax law provides an exemption for each individual taxpayer and an additional exemption for the taxpayer's spouse if a joint return is filed. An individual may also claim a dependency exemption for each dependent, provided certain tests are met. The amount of the personal and dependency exemptions is $3,650 in 2009 and $3,650 in 2010. The amount is indexed for inflation. The exemption was subject to phaseout once adjusted gross income exceeds certain statutory threshold amounts. This phaseout provision is subject to partial phaseout beginning in 2006. For 2009, two-thirds of the reduction in the exemption amount is phased out and in 2010 all of the reduction is phased out. §§ 151 and 152.

Personal service corporation (PSC). A corporation whose principal activity is the performance of personal services (e.g., health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting) and where such services are substantially performed by the employee-owners. The 35 percent statutory income tax rate applies to PSCs.

Personalty. All property that is not attached to real estate (realty) and is movable. Examples of personalty are machinery, automobiles, clothing, household furnishings, inventory, and personal effects.

Points. Loan origination fees that may be deductible as interest by a buyer of property. A seller of property who pays points reduces the selling price by the amount of the points paid for the buyer. While the seller is not permitted to deduct this amount as interest, the buyer may do so. § 461(g).

Portfolio income. Income from interest, dividends, certain rentals, royalties, capital gains, or other investment sources. Net passive losses cannot be used to offset net portfolio income. § 469.

Precedent. A previously decided court decision that is recognized as authority for the disposition of future decisions.

Precontribution gain or loss. Partnerships allow for a variety of special allocations of gain or loss among the partners, but gain or loss that is "built in" on an asset contributed to the partnership is assigned specifically to the contributing partner. § 704(c)(1)(A).

Private activity bond. Interest on state and local bonds is excludible from gross income. § 103. Certain such bonds are labeled private activity bonds. Although the interest on such bonds is excludible for regular income tax purposes, it generally is treated as a tax preference in calculating the AMT.

Procedural Regulation. A Regulation issued by the Treasury Department that is a housekeeping-type instruction indicating information that taxpayers should provide the IRS as well as information about the internal management and conduct of the IRS itself.

Production activities deduction (PAD). A deduction based on 3 percent of the lesser of qualified production activities income (QPAI) or modified adjusted gross income but not to exceed 50 percent of the W–2 production wages paid. In the case of a corporate taxpayer, taxable income is substituted for modified AGI. The deduction rate increased to 6 percent for 2007 to 2009 and increased to 9 percent for 2010 and thereafter. § 199. See also *qualified production activities income (QPAI).*

Profit and loss sharing ratios. Specified in the partnership agreement and used to determine each partner's allocation of ordinary taxable income and separately stated items. Profits and losses can be shared in different ratios. The ratios can be changed by amending the partnership agreement. § 704(a).

Profits (loss) interest. A partner's percentage allocation of partnership operating results, determined by the profit and loss sharing ratios.

Property. Assets defined in the broadest legal sense. Property includes the unrealized receivables of a cash basis taxpayer, but not services rendered. § 351.

Property dividend. Generally treated in the same manner as a cash distribution, measured by the fair market value of the property on the date of distribution. The portion of the distribution representing E & P is a dividend; any excess is treated as a return of capital. Distribution of appreciated property causes the distributing corporation to recognize gain. The distributing corporation does not recognize loss on property that has depreciated in value. §§ 301 and 311.

Property factor. The proportion of a multistate corporation's total property that is traceable to a specific state. Used in determining the taxable income that is to be apportioned to that state.

Proposed Regulation. A Regulation issued by the Treasury Department in proposed, rather than final, form. The interval between the proposal of a Regulation and its finalization permits taxpayers and other interested parties to comment on the propriety of the proposal.

Proprietorship. A business entity for which there is a single owner. The net profit of the entity is reported on the owner's Federal income tax return (Schedule C of Form 1040).

Public Law 86–272. A congressional limit on the ability of the state to force a multistate taxpayer to assign income to that state. Under P.L. 86–272, where orders for tangible personal property are both filled and delivered outside the state, the entity must establish that more than the mere solicitation of such orders took place in-state before any income can be apportioned to the state.

Punitive damages. Damages received or paid by the taxpayer can be classified as compensatory damages or as punitive damages. Punitive damages are those awarded to punish the defendant for gross negligence or the intentional infliction of harm. Such damages are includible in gross income. § 104(a)(2).

Q

Qualified dividend income. Dividends that are eligible for the beneficial 0 percent (5 percent prior to 2008) or 15 percent tax rate. Excluded are certain dividends from foreign corporations, dividends from tax-exempt entities, and dividends that do not satisfy the holding period requirement. A dividend from a foreign corporation is eligible for qualified dividend status only if one of the following requirements is met: (1) the foreign corporation's stock is traded on an established U.S. securities market, or (2) the foreign corporation is eligible for the benefits of a comprehensive income tax treaty between its country of incorporation and the United States. To satisfy the holding period requirement, the stock on which the dividend is paid must have been held for more than 60 days during the 120-day period beginning 60 days before the ex-dividend date.

Qualified employee discounts. Discounts offered employees on merchandise or services that the employer ordinarily sells or provides to customers. The discounts must be generally available to all employees. In the case of property, the discount cannot exceed the employer's gross profit (the sales price cannot be less than the employer's cost). In the case of services, the discounts cannot exceed 20 percent of the normal sales price. § 132.

Qualified nonrecourse debt. Debt issued on realty by a bank, retirement plan, or governmental agency. Included in the at-risk amount by the investor. § 465(b)(6).

Qualified production activities income (QPAI). A key determinant in computing the domestic production activities deduction (DPAD). It consists of domestic production gross receipts (DPGR) reduced by cost of goods sold and other assignable expenses. Thus, QPAI represents the profit derived from production activities. § 199. See also *domestic production gross receipts (DPGR)* and *production activities deduction (PAD).*

Qualified real property business indebtedness. Indebtedness that was incurred or assumed by the taxpayer in connection with real property used in a trade or business and is secured by such real property. The taxpayer must not be a C corporation. For qualified real property business indebtedness, the taxpayer may elect to exclude some or all of the income realized from cancellation of debt on qualified real property. If the election is made, the basis of the property must be reduced by the amount excluded. The amount excluded cannot be greater than the excess of the principal amount of the outstanding debt over the fair market value (net of any other debt outstanding on the property) of the property securing the debt. § 108(c).

Qualified residence interest. A term relevant in determining the amount of interest expense the individual taxpayer may deduct as an itemized deduction for what otherwise would be disallowed as a component of personal interest (consumer interest). Qualified residence interest consists of interest paid on qualified residences (principal residence and one other residence) of the taxpayer. Debt that qualifies as qualified residence interest is limited to $1 million of debt to acquire, construct, or substantially improve qualified residences (acquisition indebtedness) plus $100,000 of other debt secured by qualified residences (home equity indebtedness). The home equity indebtedness may not exceed the fair market value of a qualified residence reduced by the acquisition indebtedness for that residence. § 163(h)(3).

Qualified small business stock. Stock in a qualified small business corporation, purchased as part of an original issue after August 10, 1993. The shareholder may exclude from gross income 50 percent (75 percent for 2009 and 2010) of the realized gain on the sale of the stock, if he or she held the stock for more than five years. § 1202.

Qualified transportation fringes. Transportation benefits provided by the employer to the employee. Such benefits include (1) transportation in a commuter highway vehicle between the employee's residence and the place of employment, (2) a transit pass, and (3) qualified parking. Qualified transportation fringes are excludible from the employee's gross income to the extent categories (1) and (2) above do not exceed $230 per month in 2010 ($230 in 2009) and category (3) does not exceed $230 per month in 2010 ($230 in 2009). These amounts are indexed annually for inflation. § 132(f).

Qualifying child. An individual who, as to the taxpayer, satisfies the relationship, abode, and age tests. To be claimed as a dependent, such individual must also meet the citizenship and joint return tests and not be self-supporting. §§ 152(a)(1) and (c). See also *personal and dependency exemptions.*

Qualifying relative. An individual who, as to the taxpayer, satisfies the relationship, gross income, support, citizenship, and joint return tests. Such an individual can be claimed as a dependent of the taxpayer. §§ 152(a)(2) and (d). See also *personal and dependency exemptions.*

R

Rate reconciliation. Under *Generally Accepted Accounting Principles*, a footnote to the financial statements often includes a table that accounts for differences in the statutory income tax rate that applies to the entity (say, 35 percent)

and the higher or lower effective tax rate that the entity realized for the reporting period. The rate reconciliation includes only *permanent differences* between the book tax expense and the entity's *income tax provision.* The rate reconciliation table often is expressed in dollar and/or percentage terms.

Realized gain or loss. The difference between the amount realized upon the sale or other disposition of property and the adjusted basis of the property. § 1001.

Realty. Real estate.

Reasonableness requirement. The Code includes a reasonableness requirement with respect to the deduction of salaries and other compensation for services. What constitutes reasonableness is a question of fact. If an expense is unreasonable, the amount that is classified as unreasonable is not allowed as a deduction. The question of reasonableness generally arises with respect to closely held corporations where there is no separation of ownership and management. § 162(a)(1).

Recognized gain or loss. The portion of realized gain or loss subject to income taxation.

Recourse debt. Debt for which the lender may both foreclose on the property and assess a guarantor for any payments due under the loan. A lender may also make a claim against the assets of any general partner in a partnership to which debt is issued, without regard to whether the partner has guaranteed the debt.

Recovery of capital doctrine. When a taxable sale or exchange occurs, the seller may be permitted to recover his or her investment (or other adjusted basis) in the property before gain or loss is recognized.

Regular corporation. See *C corporation.*

Rehabilitation expenditures credit. A credit that is based on expenditures incurred to rehabilitate industrial and commercial buildings and certified historic structures. The credit is intended to discourage businesses from moving from older, economically distressed areas to newer locations and to encourage the preservation of historic structures. § 47.

Rehabilitation expenditures credit recapture. When property that qualifies for the rehabilitation expenditures credit is disposed of or ceases to be used in the trade or business of the taxpayer, some or all of the tax credit claimed on the property may be recaptured as additional tax liability. The amount of the recapture is the difference between the amount of the credit claimed originally and what should have been claimed in light of the length of time the property was actually held or used for qualifying purposes. § 50.

Related corporation. See *controlled group.*

Related-party transactions. Various Code Sections define related parties and often include a variety of persons within this (usually detrimental) category. Generally, related parties are accorded different tax treatment from that applicable to other taxpayers who enter into similar transactions. For instance, realized losses that are generated between related parties are not recognized in the year of the loss (§ 267). However, these deferred losses can be used to offset recognized gains that occur upon the subsequent sale of the asset to a nonrelated party. Other uses of a related-party definition include the conversion of gain upon the sale of a depreciable asset into all ordinary income (§ 1239) and the identification of constructive ownership of stock relative to corporate distributions, redemptions, liquidations, reorganizations, and compensation.

Rental activity. Any activity where payments are received principally for the use of tangible property is a rental activity. Temporary Regulations provide that in certain circumstances activities involving rentals of real and personal property are not to be *treated* as rental activities. The Temporary Regulations list six exceptions.

Research activities credit. A tax credit whose purpose is to encourage research and development. It consists of three components: the incremental research activities credit, the basic research credit, and the energy credit. The incremental research activities credit is equal to 20 percent of the excess qualified research expenditures over the base amount. The basic research credit is equal to 20 percent of the excess of basic research payments over the base amount. § 41.

Research and experimental expenditures. The Code provides three alternatives for the tax treatment of research and experimental expenditures. They may be expensed in the year paid or incurred, deferred subject to amortization, or capitalized. If the taxpayer does not elect to expense such costs or to defer them subject to amortization (over 60 months), the expenditures must be capitalized. § 174. Three types of research activities credits are available: the basic research credit, the incremental research activities credit, and the energy credit. The rate for each type is 20 percent. § 41.

Reserve method. A method of accounting whereby an allowance is permitted for estimated uncollectible accounts. Actual write-offs are charged to the reserve, and recoveries of amounts previously written off are credited to the reserve. The Code permits only certain financial institutions to use the reserve method. § 166.

Residential rental real estate. Buildings for which at least 80 percent of the gross rents are from dwelling units (e.g., an apartment building). This type of building is distinguished from nonresidential (commercial or industrial) buildings in applying the recapture of depreciation provisions. The term also is relevant in distinguishing between buildings that are eligible for a 27.5-year life versus a 39-year life for MACRS purposes. Generally, residential buildings receive preferential treatment. § 168(e)(2)(A).

Revenue Procedure. A matter of procedural importance to both taxpayers and the IRS concerning the administration of the tax laws is issued as a Revenue Procedure (abbreviated Rev.Proc.). A Revenue Procedure is first published in an *Internal Revenue Bulletin* (I.R.B.) and later transferred to the appropriate *Cumulative Bulletin* (C.B.). Both the *Internal Revenue Bulletins* and the *Cumulative Bulletins* are published by the U.S. Government Printing Office.

Revenue Ruling. A Revenue Ruling (abbreviated Rev.Rul.) is issued by the National Office of the IRS to express an official interpretation of the tax law as applied to specific transactions. It is more limited in application than a Regulation. A Revenue Ruling is first published in an *Internal Revenue Bulletin* (I.R.B.) and later transferred to the appropriate *Cumulative Bulletin* (C.B.). Both the *Internal Revenue Bulletins* and the *Cumulative Bulletins* are published by the U.S. Government Printing Office.

S

S corporation. The designation for a small business corporation. See also *Subchapter S.*

Sale or exchange. A requirement for the recognition of capital gain or loss. Generally, the seller of property must receive money or relief from debt in order to have sold the property. An exchange involves the transfer of property for other property. Thus, collection of a debt is neither a sale nor an exchange. The term *sale or exchange* is not defined by the Code.

Sales factor. The proportion of a multistate corporation's total sales that is traceable to a specific state. Used in determining the taxable income that is to be apportioned to that state.

Sales tax. A state- or local-level tax on the retail sale of specified property. Generally, the purchaser pays the tax, but the seller collects it, as an agent for the government. Various taxing jurisdictions allow exemptions for purchases of specific items, including certain food, services, and manufacturing equipment. If the purchaser and seller are in different states, a use tax usually applies.

Schedule M–1. On the Form 1120, a reconciliation of book net income with Federal taxable income. Accounts for timing and permanent differences in the two computations, such as depreciation differences, exempt income, and nondeductible items. On Forms 1120S and 1065, the Schedule M–1 reconciles book income with owners' aggregate ordinary taxable income.

Schedule M–3. An *expanded* reconciliation of book net income with Federal taxable income (see *Schedule M–1*). Applies to corporations with total assets of $10 million or more.

Scholarships. Scholarships are generally excluded from the gross income of the recipient unless the payments are a disguised form of compensation for services rendered. However, the Code imposes restrictions on the exclusion. The recipient must be a degree candidate. The excluded amount is limited to amounts used for tuition, fees, books, supplies, and equipment required for courses of instruction. Amounts received for room and board are not eligible for the exclusion. § 117.

Section 179 expensing election. The ability to deduct a capital expenditure in the year an asset is placed in service rather than over the asset's useful life or cost recovery period. The annual ceiling on the deduction is $250,000 for 2010 ($250,000 for 2009). However, the deduction is reduced dollar for dollar when § 179 property placed in service during the taxable year exceeds $800,000 in 2010 ($800,000 in 2009). In addition, the amount expensed under § 179 cannot exceed the aggregate amount of taxable income derived from the conduct of any trade or business by the taxpayer.

Section 1231 gains and losses. If the combined gains and losses from the taxable dispositions of § 1231 assets plus the net gain from business involuntary conversions (of both § 1231 assets and long-term capital assets) is a gain, the gains and losses are treated as long-term capital gains and losses. In arriving at § 1231 gains, however, the depreciation recapture provisions (e.g., §§ 1245 and 1250) are first applied to produce ordinary income. If the net result of the combination is a loss, the gains and losses from § 1231 assets are treated as ordinary gains and losses. § 1231(a).

Section 1231 lookback. In order for gain to be classified as § 1231 gain, the gain must survive the § 1231 lookback. To the extent of nonrecaptured § 1231 losses for the five prior tax years, the gain is classified as ordinary income. § 1231(c).

Section 1231 property. Depreciable assets and real estate used in trade or business and held for the required long-term holding period. Under certain circumstances, the classification also includes timber, coal, domestic iron ore, livestock (held for draft, breeding, dairy, or sporting purposes), and unharvested crops. § 1231(b).

Section 1245 property. Property that is subject to the recapture of depreciation under § 1245. For a definition of § 1245 property, see § 1245(a)(3).

Section 1245 recapture. Upon a taxable disposition of § 1245 property, all depreciation claimed on the property is recaptured as ordinary income (but not to exceed recognized gain from the disposition).

Section 1250 property. Real estate that is subject to the recapture of depreciation under § 1250. For a definition of § 1250 property, see § 1250(c).

Section 1250 recapture. Upon a taxable disposition of § 1250 property, some of the depreciation or cost recovery claimed on the property may be recaptured as ordinary income.

Securities. Generally, stock, debt, and other financial assets. To the extent securities other than the stock of the transferee corporation are received in a § 351 exchange, the new shareholder realizes a gain.

Self-employment tax. In 2010, a tax of 12.4 percent is levied on individuals with net earnings from self-employment (up to $106,800) to provide Social Security benefits (i.e., the old age, survivors, and disability insurance portion) for such individuals. In addition, in 2010, a tax of 2.9 percent is levied on individuals with net earnings from self-employment (with no statutory ceiling) to provide Medicare benefits (i.e., the hospital insurance portion) for such individuals. If a self-employed individual also receives wages from an employer that are subject to FICA, the self-employment tax will be reduced if total income subject to Social Security is more than $106,800 in 2010. A partial deduction is allowed in calculating the self-employment tax. Individuals with net earnings of $400 or more from self-employment are subject to this tax. §§ 1401 and 1402.

Separate foreign tax credit limitation category. The foreign tax credit of a taxpayer is computed for each of several types of income sources, as specified by the Code to limit the results of tax planning. FTC income "baskets" include general and passive. The FTC for the year is the sum of the credits as computed within all of the taxpayer's separate FTC baskets used for the tax year.

Separately stated item. Any item of a partnership or S corporation that might be taxed differently to any two owners of the entity. These amounts are not included in ordinary income of the entity, but are instead reported separately to the owners; tax consequences are determined at the owner level. §§ 702(a) and 1366(a)(1).

Short sale. A short sale occurs when a taxpayer sells borrowed property (usually stock) and repays the lender with substantially identical property either held on the date of the short sale or purchased after the sale. No gain or loss is recognized until the short sale is closed, and such gain or loss is generally short term. § 1233.

Significant participation activity. There are seven tests to determine whether an individual has achieved material participation in an activity, one of which is based on more than 500 hours of participation in significant participation activities. A significant participation activity is one in which the individual's participation exceeds 100 hours during the year. Temp.Reg. § 1.469–5T.

Small business corporation. A corporation that satisfies the definition of § 1361(b), § 1244(c), or both. Satisfaction of § 1361(b) permits an S election, and satisfaction of § 1244 enables the shareholders of the corporation to claim an ordinary loss on the worthlessness of stock.

Small business stock. See *small business corporation.*

Small Cases Division of the U.S. Tax Court. Jurisdiction is limited to claims of $50,000 or less. There is no appeal from this court.

Solicitation. A level of activity brought about by the taxpayer within a specific state. Under Public Law 86-272, certain types of solicitation activities do not create nexus with the state. Exceeding mere solicitation, though, creates nexus.

Special allocation. Any amount for which an agreement exists among the partners of a partnership outlining the method used for spreading the item among the partners.

Specific charge-off method. A method of accounting for bad debts in which a deduction is permitted only when an account becomes partially or completely worthless.

Standard deduction. The individual taxpayer can either itemize deductions or take the standard deduction. The amount of the standard deduction depends on the taxpayer's filing status (single, head of household, married filing jointly, surviving spouse, or married filing separately). For 2010, the amount of the standard deduction ranges from $5,700 (for married, filing separately or unmarried) to $11,400 (for married, filing jointly). Additional standard deductions of either $1,100 (for married taxpayers) or $1,400 (for single taxpayers) are available if the taxpayer is either blind or age 65 or over. For 2008 and 2009, a real property tax standard deduction is available in the amount of $500 ($1,000 on a joint return). For 2009, the standard deduction also includes a motor vehicle sales tax component. Limitations exist on the amount of the standard deduction of a taxpayer who is another taxpayer's dependent. The standard deduction amounts are adjusted for inflation each year. § 63(c).

Stock dividend. Not taxable if pro rata distributions of stock or stock rights on common stock. Section 305 governs the taxability of stock dividends and sets out five exceptions to the general rule that stock dividends are nontaxable.

Stock redemption. A corporation buys back its own stock from a specified shareholder. Typically, the corporation recognizes any realized gain on the noncash assets that it uses to effect a redemption, and the shareholder obtains a capital gain or loss upon receipt of the purchase price. §§ 301 and 302.

Subchapter S. Sections 1361–1379 of the Internal Revenue Code. An elective provision permitting certain small business corporations (§ 1361) and their shareholders (§ 1362) to elect to be treated for income tax purposes in accordance with the operating rules of §§ 1363–1379. S corporations usually avoid the corporate income tax, and corporate losses can be claimed by the shareholders.

Subpart F income. Certain income earned by a controlled foreign corporation. Usually, Subpart F income is included in the gross income of a U.S. shareholder of the CFC when the income is earned, not when it is later repatriated.

Supreme Court. The highest appellate court or the court of last resort in the Federal court system and in most states. Only a small number of tax decisions of the U.S. Courts of Appeal are reviewed by the U.S. Supreme Court under its certiorari procedure. The Supreme Court usually grants certiorari to resolve a conflict among the Courts of Appeal (e.g., two or more appellate courts have assumed opposing positions on a particular issue) or when the tax issue is extremely important (e.g., size of the revenue loss to the Federal government).

Surviving spouse. When a husband or wife predeceases the other spouse, the survivor is known as a surviving spouse. Under certain conditions, a surviving spouse may be entitled to use the income tax rates in § 1(a) (those applicable to married persons filing a joint return) for the two years after the year of death of his or her spouse. § 2.

Syndication costs. Incurred in promoting and marketing partnership interests for sale to investors. Examples include legal and accounting fees, printing costs for prospectus and placement documents, and state registration fees. These items are capitalized by the partnership as incurred, with no amortization thereof allowed.

T

Tax avoidance. The minimization of one's tax liability by taking advantage of legally available tax planning opportunities. Tax avoidance can be contrasted with tax evasion, which entails the reduction of tax liability by illegal means.

Tax benefit rule. A provision that limits the recognition of income from the recovery of an expense or loss properly deducted in a prior tax year to the amount of the deduction that generated a tax saving. Assume that last year Gary had medical expenses of $3,000 and adjusted gross income of $30,000. Because of the 7.5 percent limitation, Gary could deduct only $750 of these expenses [$3,000 − (7.5% × $30,000)]. If, this year, Gary is reimbursed by his insurance company for $900 of these expenses, the tax benefit rule limits the amount of income from the reimbursement to $750 (the amount previously deducted with a tax saving). § 111.

Tax Court. The U.S. Tax Court is one of four trial courts of original jurisdiction that decides litigation involving Federal income, death, or gift taxes. It is the only trial court where the taxpayer must not first pay the deficiency assessed by the IRS. The Tax Court will not have jurisdiction over a case unless a statutory notice of deficiency (90-day letter) has been issued by the IRS and the taxpayer files the petition for hearing within the time prescribed.

Tax credits. Tax credits are amounts that directly reduce a taxpayer's tax liability. The tax benefit received from a tax credit is not dependent on the taxpayer's marginal tax rate, whereas the benefit of a tax deduction or exclusion is dependent on the taxpayer's tax bracket.

Tax evasion. The reduction of the taxpayer's tax liability through the use of illegal means. Tax evasion can be contrasted with tax avoidance, which entails the reduction of tax liability through the use of legal means.

Tax preference items. Various items that may result in the imposition of the alternative minimum tax. §§ 55–58.

Tax rate schedules. Rate schedules that are used by upper-income taxpayers and those not permitted to use the tax table. Separate rate schedules are provided for married individuals filing jointly, head of household, single taxpayers, estates and trusts, and married individuals filing separate returns. § 1.

Tax shelters. The typical tax shelter generated large losses in the early years of the activity. Investors would offset these losses against other types of income and, therefore, avoid paying income taxes on this income. These tax shelter investments could then be sold after a few years and produce capital gain income, which is taxed at a lower rate than ordinary income. The passive activity loss rules and the at-risk rules now limit tax shelter deductions.

Tax table. A tax table that is provided for taxpayers with less than $100,000 of taxable income. Separate columns are provided for single taxpayers, married taxpayers filing jointly, head of household, and married taxpayers filing separately. § 3.

Taxable year. The annual period over which income is measured for income tax purposes. Most individuals use a calendar year, but many businesses use a fiscal year based on the natural business year.

Technical advice memoranda (TAMs). TAMs are issued by the National Office of the IRS in response to questions raised by IRS field personnel during audits. They deal with completed rather than proposed transactions and are often requested for questions related to exempt organizations and employee plans.

Temporary differences. Under *ASC 740* (*SFAS 109*), tax-related items that appear in the entity's financial statements and its tax return, but in different time periods. For instance, doubtful accounts receivable often create a temporary book-tax difference, as a bad debt reserve is used to compute an expense for financial reporting purposes, but a bad debt often is deductible only under the specific write-off rule for tax purposes, and the difference observed for the current period creates a temporary difference.

Temporary Regulation. A Regulation issued by the Treasury Department in temporary form. When speed is critical, the Treasury Department issues Temporary Regulations that take effect immediately. These Regulations have the same authoritative value as Final Regulations and may be cited as precedent for three years. Temporary Regulations are also issued as proposed Regulations.

Theft loss. A loss from larceny, embezzlement, or robbery. It does not include misplacement of items.

Thin capitalization. When debt owed by a corporation to the shareholders becomes too large in relation to the corporation's capital structure (i.e., stock and shareholder equity), the IRS may contend that the corporation is thinly capitalized. In effect, this means that some or all of the debt is reclassified as equity. The immediate result is to disallow any interest deduction to the corporation on the reclassified debt. To the extent of the corporation's earnings and profits, interest payments and loan repayments on the reclassified debt are treated as dividends to the shareholders. § 385.

Throwback rule. If there is no income tax in the state to which a sale otherwise would be apportioned, the sale essentially is exempt from state income tax, even though the seller is domiciled in a state that levies an income tax. Nonetheless, if the seller's state has adopted a throwback rule, the sale is attributed to the seller's state, and the transaction is subjected to a state-level tax.

Transportation expenses. Transportation expenses for an employee include only the cost of transportation (taxi fares, automobile expenses, etc.) in the course of employment when the employee is not away from home in travel status. Commuting expenses are not deductible.

Travel expenses. Travel expenses include meals (generally subject to a 50 percent disallowance) and lodging and transportation expenses while away from home in the pursuit of a trade or business (including that of an employee).

U

Unearned income. Income received but not yet earned. Normally, such income is taxed when received, even for accrual basis taxpayers. In certain cases involving advance payments for goods and services, income may be deferred. See Revenue Procedure 2004–34 (2004–1 C.B. 991) and Reg. § 1.451–5.

Unitary approach. Sales, property, and payroll of related corporations are combined for nexus and apportionment purposes, and the worldwide income of the unitary entity is apportioned to the state. Subsidiaries and other affiliated corporations found to be part of the corporation's unitary business (because they are subject to overlapping ownership, operations, or management) are included in the apportionment procedure. This approach can be limited if a waters'-edge election is in effect.

Unreasonable compensation. A deduction is allowed for "reasonable" salaries or other compensation for personal services actually rendered. To the extent compensation is "excessive" ("unreasonable"), no deduction is allowed. The problem of unreasonable compensation usually is limited to closely held corporations, where the motivation is to pay out profits in some form that is deductible to the corporation. Deductible compensation therefore becomes an attractive substitute for nondeductible dividends when the shareholders also are employed by the corporation. § 162(a)(1).

Unrecaptured § 1250 gain (25 percent gain). Gain from the sale of depreciable real estate held more than one year. The gain is equal to or less than the depreciation taken on such property and is reduced by § 1245 and § 1250 gain.

U.S. shareholder. For purposes of classification of an entity as a controlled foreign corporation, a U.S. person who owns, or is considered to own, 10 percent or more of the total combined voting power of all classes of voting stock of a foreign corporation. Stock owned directly, indirectly, and constructively is counted for this purpose. The U.S. shareholder may be currently taxed on a proportionate share of Subpart F income.

U.S. trade or business. A set of activities that is carried on in a regular, continuous, and substantial manner. A non-U.S. taxpayer is subject to U.S. tax on the taxable income that is effectively connected with a U.S. trade or business.

Use tax. A sales tax that is collectible by the seller where the purchaser is domiciled in a different state.

V

Valuation allowance. Under *ASC 740* (*SFAS 109*), a tax-related item is reported for book purposes only when it is more likely than not that the item actually will be realized. When the "more likely than not" test is failed, a contra-asset account is created to offset some or all of the related *deferred tax asset*. For instance, if the entity projects that it will not be able to use all of its *net operating loss* carryforward due to a lack of future taxable income, a valuation allowance is created to reduce the net *deferred tax asset* that corresponds to the carryforward. If income projections later change and it appears that the carryforward will be used, the valuation allowance is reversed or "released." Creation of a valuation allowance usually increases the *current tax expense* and thereby reduces current book income, and its release often increases book income in the later reporting period.

Value added tax (VAT). A national sales tax that taxes the increment in value as goods move through the production process. A VAT is much used in other countries but has not yet been incorporated as part of the U.S. Federal tax structure.

Voluntary revocation. The owners of a majority of shares in an S corporation elect to terminate the S status of the entity, as of a specified date. The day on which the revocation is effective is the first day of the corporation's C tax year.

W

W–2 wages. The domestic production activities deduction (DPAD) cannot exceed 50 percent of the W–2 wages paid for any particular year. Prop.Reg. § 199–2(f)(2) provides several methods for calculating the W–2 wages, but the payments must involve common law employees. To qualify, the employees need to be involved in the production process. § 199. See also *production activities deduction (PAD).*

Wash sale. A loss from the sale of stock or securities that is disallowed because the taxpayer, within 30 days before or after the sale, has acquired stock or securities substantially identical to those sold. § 1091.

Waters'-edge election. A limitation on the worldwide scope of the unitary approach to computing state taxable income. If a waters'-edge election is in effect, the state can consider only the activities that occur within the boundaries of the United States in the apportionment procedure.

Welfare-to-work credit. A tax credit available to employers hiring individuals who have been long-term recipients of family assistance welfare benefits. In general, long-term recipients are those individuals who are certified by a designated local agency as being members of a family receiving assistance under a public aid program for at least an 18-month period ending on the hiring date. The welfare-to-work credit is available for qualified wages paid in the first two years of employment. The maximum credit is equal to $9,000 per qualified employee, computed as 40 percent of the first $10,000 of qualified wages paid in the first year of employment, plus 50 percent of the first $10,000 of qualified wages paid in the second year of employment. Starting in 2007, the welfare-to-work credit became part of the work opportunity tax credit. § 51(e). See also *work opportunity tax credit.*

Wherewithal to pay. This concept recognizes the inequity of taxing a transaction when the taxpayer lacks the means with which to pay the tax. Under it, there is a correlation between the imposition of the tax and the ability to pay the tax. It is particularly suited to situations in which the taxpayer's economic position has not changed significantly as a result of the transaction.

Work opportunity tax credit. Employers are allowed a tax credit equal to 40 percent of the first $6,000 of wages (per eligible employee) for the first year of employment. Eligible employees include certain hard-to-employ individuals (e.g., qualified ex-felons, high-risk youth, food stamp recipients, and veterans). The employer's deduction for wages is reduced by the amount of the credit taken. For qualified summer youth employees, the 40 percent rate is applied to the first $3,000 of qualified wages. See the *welfare-to-work credit* for the calculation for long-term recipients of family assistance welfare benefits. §§ 51 and 52.

Working condition fringe. A type of fringe benefit received by the employee that is excludible from the employee's gross income. It consists of property or services provided (paid or reimbursed) by the employer for which the employee could take a tax deduction if the employee had paid for them. § 132(d).

Worthless securities. A loss (usually capital) is allowed for a security that becomes worthless during the year. The loss is deemed to have occurred on the last day of the year. Special rules apply to securities of affiliated companies and small business stock. § 165.

Writ of Certiorari. Appeal from a U.S. Court of Appeals to the U.S. Supreme Court is by Writ of Certiorari. The Supreme Court need not accept the appeal, and it usually does not (*cert. den.*) unless a conflict exists among the lower courts that must be resolved or a constitutional issue is involved.

Appendix D-1

TABLE OF CODE SECTIONS CITED

[See Title 26 U.S.C.A.]

I.R.C. Sec.	This Work Page
1	2-7, 16-24
1-5	2-5
1(g)(2)	16-27
1(h)	4-30
1(h)(7)	8-18
1(h)(11)	4-15
2	2-7, 2-8
2(a)	2-5, 16-22
2(a)(1)(A)	2-6, 2-7
2(b)	16-22
5	2-5
6	2-5
7	2-5
8	2-5
9	2-5
10	2-5
11	2-5, 15-14
11-12	2-5
11(b)(2)	9-32
12(d)	2-7
21	16-54
21(d)	16-55
22(e)(3)	16-12
23	16-53
24	16-54, 16-71
24(a)	16-54
24(b)	16-54
27	14-12, 14-14, 14-15
32	16-58, 16-71
32(c)(2)(A)	2-37
38	14-14
38(c)	14-4
38(c)(3)(B)	14-4
39(a)(1)	14-4
41	5-17, 14-8, 14-14
41(b)(3)(A)	14-8
41(b)(3)(D)	14-8
41(c)(4)	14-8
41(d)	14-9
41(e)	14-10
42	14-14
44	14-10, 14-14, 15-14
45E	14-11, 14-14
45F	14-11, 14-14, 14-15
45F(d)	14-12
47	14-5, 14-14
50(c)	14-6
51	14-7, 14-14
51(d)(1)(I)	14-8
51A	14-8
55	15-9
55 through 59	14-15
55(e)	15-14
56(a)(1)	14-20
56(a)(1)(A)(i)	14-19
56(a)(3)	14-21
56(a)(5)	14-21
56(a)(6)	14-22
56(c)(1)	15-10
56(f)	15-10
56(g)(1)	14-25
56(g)(2)	14-25
56(g)(3)	14-26
57(a)(1)	14-17
57(a)(5)	14-17
61	4-3, 4-4, 9-10, 13-6, 17-18
61(a)	1-20, 16-4, 17-43
61(a)(3)	7-6
61(a)(12)	4-26
61(a)(13)	2-36
61(a)(18)	17-31
62	16-6
62(a)(1)	6-11, 17-3
62(a)(2)	17-36
62(a)(2)(B)	16-52
62(a)(2)(D)	17-35

I.R.C. Sec.	This Work Page
62(a)(4)	16-36
63(c)(1)	16-8
63(c)(5)	16-10
67	17-16, 17-31
67(a)	17-4
68	16-53
71	16-29
71-90	4-18, 16-28, 16-29
71(c)(2)	16-30
72	17-42
74	16-30
74(b)	16-30
74(c)	16-31
78	13-12
79	17-10
79(d)	17-11, 17-18
83	9-10
83(a)	11-11
85	16-31
86	16-31, 17-7, 17-38
101	4-18, 4-25, 17-7
101-140	16-28
101-150	4-18
101(a)(2)	4-25
102	4-18, 16-32
102(c)	16-32
103	4-18, 5-13
103(a)	4-23, 14-37
103(b)(1)	14-37
104(a)(1)	16-34
104(a)(2)	16-34
104(a)(3)	16-35
105	17-6, 17-7
105(a)	17-6
105(b)	17-6
105(c)	17-6
105(h)	17-18
105(h)(2)	10-20
106	17-6, 17-7
108	4-18, 4-27
108(a)(1)(D)	4-28
108(b)	4-27
108(e)(5)	4-28
108(e)(6)	4-29
108(f)	4-29
109	4-18, 4-24, 7-19
111(a)	4-22
117	4-18
117(a)	16-32
117(b)	16-33
117(d)	17-11
118	9-24
119	17-8
119(a)	17-8
121	7-2, 7-32, 16-45, 17-7
125	17-12
125(f)	17-12
127	17-12
127(b)(2)	17-18
129	17-11
132	17-3, 17-14
132(a)(7)	17-17
132(c)	17-15
132(d)	17-16
132(e)	17-16
132(f)	17-17
132(j)(1)	17-18
132(j)(3)	17-16
132(j)(4)	17-12
132(m)	17-17
132(m)(2)	17-18
135	16-35, 17-38
137	17-12
141	14-18
151	16-71
151(b)	16-11
151(d)(3)	16-18
152	16-71
152(b)(2)	16-17
152(b)(3)	16-17
152(c)	16-12
152(c)(4)	16-13
152(d)	16-13
152(d)(2)(H)	16-14
152(d)(3)	16-15
152(e)(2)	16-16
152(e)(5)	16-16
152(f)(2)	16-12
152(f)(3)	2-37, 16-14
152(f)(5)	16-12
152(f)(6)	16-12
162	5-3, 5-4, 5-8, 9-22, 14-11, 17-43
162(a)	5-3, 17-3, 17-23
162(a)(1)	5-3, 15-11
162(a)(2)	17-64
162(c)	5-7
162(c)(2)	17-64
162(e)	5-8
162(f)	5-7
162(g)	5-7
162(l)	17-43
162(m)	5-9, 5-52
163(d)	16-44
163(h)(3)	16-45
163(h)(3)(E)(i)	16-46
163(h)(3)(E)(ii)	16-46
163(i)(8)(B)	5-30
164	13-11, 16-41
164(f)	17-44, 17-46
165(a)	7-6
165(c)(3)	6-11
165(g)	6-6
165(g)(1)	8-8
165(h)	6-9, 6-11
165(h)(4)(E)	6-10
166(a)	6-3
167	7-19, 8-30
168	7-19, 8-30

I.R.C. Sec.	This Work Page
168(b)	5-25, 5-28
168(b)(2)(B)	5-29
168(b)(3)(E)	5-29
168(b)(5)	5-29
168(c)	5-28
168(d)(1)	5-28
168(d)(3)	5-26
168(d)(4)(A)	5-25
168(e)	5-24, 5-28
168(e)(3)(D)(ii)	5-29
168(g)	5-36
168(g)(2)	10-5
168(k)	5-26, 8-30
168(k)(2)(D)	10-5
170	5-14, 16-47
170(b)	5-16
170(c)	5-14, 16-47
170(d)	5-16, 16-50
170(e)(1)(A)	8-36
170(e)(1)(B)	8-36
170(e)(3)	5-16
170(e)(4)	5-16
170(e)(6)	5-16
170(f)	16-49
170(i)	16-48
170(j)	16-48
170(l)	16-47
171(c)	7-6
172	6-13
172(b)(1)(F)	6-13
174	5-17, 5-51, 14-9
174(b)(2)	5-18
179	1-39, 5-1, 5-2, 5-22, 5-29, 5-30, 5-31, 5-32, 5-34, 5-45, 5-48, 5-49, 5-50, 7-19, 8-30, 8-31, 8-32, 8-34, 9-32, 9-33, 10-6, 10-7, 10-28, 10-29, 10-30, 11-6, 11-16, 11-18, 14-33, 15-14, 17-21, 17-25, 17-61
179(b)	5-31
179(b)(6)	5-34
179(d)	5-31
179(d)(6)	9-32
183	17-2, 17-50, 17-51
183(b)(2)	17-50
183(d)	17-50
195	9-31, 11-15
195(b)	5-11
197	3-6, 5-36, 5-37, 8-30, 8-34, 11-12, 15-22
197(a)	5-36
199	5-20, 11-16, 11-18, 11-44
199(a)	5-20, 11-18
199(b)	5-21, 11-18
199(c)	5-21
199(c)(4)	5-21
199(d)(1)	11-18
199(d)(2)	5-20
211	2-6
212	5-13, 16-36, 16-52
212(1)	2-6
213(d)	16-37
215	16-29
217	17-17, 17-20
217(a)	17-25
217(b)	17-26
219(b)(1)	17-38
219(c)(2)	17-38
219(g)	17-38
219(g)(7)	17-39
221	16-43, 17-31
221(b)(2)(C)	16-43
222	17-31, 17-58
222(b)(2)	17-30
222(c)	17-31
222(d)(1)	17-31
222(d)(4)	17-31
223	16-39, 17-7
223(b)(2)	16-41
223(b)(8)	16-41
223(c)(2)	16-40
223(d)	16-40
223(f)	16-40
241	2-6
243(a)	9-28
245	9-28
246(b)(2)	9-28
246(c)	9-29
248	9-30, 9-31, 9-45
262	8-14, 16-52
263(a)(1)	5-9
263A(d)(3)(A)	5-29
263A(e)(4)	5-29
265	5-13
265(a)(2)	16-46
267	2-25, 5-12, 5-46, 7-16, 8-14, 10-4, 11-31
267(a)	2-20, 2-25, 2-26
267(a)(1)	2-20, 5-11, 7-7
267(b)	2-20, 7-23, 12-25
267(b)(2)	2-20, 2-25, 2-26
267(c)	2-20
267(c)(2)	2-25, 2-26
267(c)(4)	2-20, 2-26
269A	15-19
274	5-36
274(a)(1)(A)	17-32
274(a)(3)	17-33
274(b)(1)	17-33
274(c)	17-24
274(d)	5-36, 17-37
274(i)	5-36
274(j)	16-31
274(k)	17-33
274(n)	17-31
275	16-41
276	5-8
280A through 280H	2-5
280A(c)(1)	17-34
280C(c)	14-9
280E	5-8
280F	5-32, 5-52

I.R.C. Sec.	This Work Page
280F(a)(1)	5-33
280F(b)(1)	5-35
280F(b)(2)	5-35
280F(b)(3)	5-33
280F(d)(1)	5-34
280F(d)(5)	5-33
291	8-35
291(a)(1)	8-35
301	10-12
301(c)	10-3
301(c)(1)	10-2
302	10-22, 15-8, 15-19
302(b)(1)	10-23
302(b)(2)	10-23
302(b)(3)	10-22, 15-40, 15-42
302(b)(4)	10-23
303	10-23
305(a)	7-10
307(a)	7-10, 10-21
311	10-13, 10-23
311(b)	12-19, 15-18, 15-19
311(b)(2)	10-14
312	10-4
312(a)	10-14
312(b)	10-14
312(c)	10-14
312(d)(1)	10-21
312(f)(1)	10-5
312(k)(3)(A)	10-5
312(k)(3)(B)	10-6
312(n)	10-6
312(n)(5)	10-5
312(n)(7)	10-23
316(a)	10-2
318	10-23, 10-33
331	10-25, 15-19
332	8-37
336	15-19
351	7-2, 7-31, 8-37, 9-9, 9-10, 9-11, 9-12, 9-13, 9-14, 9-15, 9-18, 9-20, 9-21, 9-22, 9-23, 9-42, 9-44, 11-12, 11-29, 12-20, 15-4, 15-16, 15-24, 15-25, 15-26, 15-27, 15-28
351(a)	9-18, 9-23
351(b)	9-9, 9-11, 9-16
351(b)(2)	9-18
351(g)	9-11
357	9-2, 9-15
357(a)	9-15
357(b)	9-15, 9-16, 9-17
357(c)	9-15, 9-16, 9-17, 9-50
357(c)(2)(A)	9-17
358(a)	9-10, 9-19
362(a)	9-19
362(c)	9-25
362(e)(2)	9-21
367	9-15
368(c)	9-11
385	9-26, 9-27, 15-11
385(a)	2-23
401(c)(2)	17-46
401(c)(2)(A)(v)	17-46
401(k)	6-22, 10-12, 13-27, 16-29, 17-47, 17-48
408(m)	8-18
408(p)	17-47
408A	17-40
414(q)	17-17
415(b)(1)	17-46
415(c)(1)	17-45
446(a)	5-5
446(b)	4-7, 5-5
446(e)	5-5
448(a)	4-9
448(b)	4-9
448(d)(2)(A)	6-22
451(h)	4-12
453	4-7
457	5-21
460	4-7
461(g)(1)	16-47
461(g)(2)	16-46
461(h)	5-6
461(h)(3)(A)	5-6
465(a)	11-28
465(b)(1)	6-17
465(b)(6)	6-17, 11-29, 15-20
465(e)	6-17
469	6-18, 15-19, 15-20, 17-38
469(a)	6-21, 14-23
469(b)	6-20
469(c)(2)	6-28
469(c)(7)	6-30
469(c)(7)(B)	6-31
469(d)(2)	6-20
469(f)	6-21
469(g)(2)	6-33
469(i)	6-32
469(i)(6)	6-32
469(j)(5)	6-32
469(j)(6)	6-34
469(j)(8)	6-28
474	2-30
482	9-34, 13-17, 13-32
509	5-15
530	17-41
531	15-8, 15-13
531-537	10-26
541-547	10-26
611(a)	5-38
612	5-38
613(a)	5-39
613A	5-39
613A(c)	14-17
631	8-25
643(a)(2)	2-36
701	11-5, 15-18
702	11-5, 15-18
702(a)	11-16
702(b)	11-16
703(a)(1)	11-6
703(a)(2)	12-11

I.R.C. Sec.	This Work Page
703(b)	11-14
704(a)	11-8, 11-19
704(b)	11-8, 11-20
704(c)(1)(A)	11-20
704(d)	11-26
705	11-9, 11-22, 15-17
707	2-25, 7-16
707(a)	11-31
707(a)(2)(B)	11-11
707(b)	11-31
707(b)(2)	11-32
707(c)	11-30, 15-19
708(a)	2-37
708(b)(1)(B)	15-23
709(a)	11-15
709(b)(2)	11-15
721	7-2, 7-31, 8-37, 11-9, 11-10, 11-11, 11-29, 15-4, 15-15, 15-16, 15-23, 15-25
721(b)	11-10
722	11-9
723	11-9, 11-11
724	11-12
724(c)	11-13
724(d)(2)	11-12
731	11-10, 11-11, 15-19
731(a)	11-19
743	15-23
751	15-27, 15-28
751(a)	11-25
751(d)	11-25
752	11-22, 11-35, 15-17
752(a)	12-21
754	15-23, 15-24
761(a)	11-5
861 through 865	13-8
861(a)(2)	13-8
863(b)	13-11
865	13-10
901	13-12
901-908	14-12
902	13-12, 13-39
903	13-12
904	13-12
904(c)	14-13
911	17-19, 17-38
965	13-16
1001	15-19
1001(a)	7-3, 11-9
1001(b)	7-3
1001(c)	7-6, 11-9
1011	7-13
1011(a)	7-4
1012	7-8
1014(a)	7-14
1014(e)	7-15
1015(a)	7-11
1015(d)(6)	7-12
1016(a)	7-4
1016(a)(2)	7-5
1016(a)(4)	7-6
1016(a)(5)	7-6
1017	4-27
1031	7-2, 7-20, 7-21, 7-22, 7-23, 7-24, 7-25, 7-29, 7-31, 7-32, 7-41, 8-37, 9-8, 9-9, 9-15, 11-12
1031(a)	7-20
1031(a)(3)	7-23
1032	7-2, 7-31, 9-22, 9-24
1033	7-2, 7-27, 7-28, 8-26
1033(a)	7-28, 7-29
1033(a)(2)(B)	7-30
1033(b)(2)	7-27
1033(g)(4)	7-30
1035	7-2, 7-31
1036	7-2, 7-31
1041	7-2, 7-33, 16-29
1044	7-2, 7-32
1045	15-14
1045(a)	8-23
1059	10-34
1060	7-10
1091	2-25, 7-16
1091(a)	2-26, 7-16
1091(b)	7-17
1091(d)	7-17
1201	8-24
1202	12-35, 15-14
1202(a)	8-22
1211	4-31
1211(b)	8-16
1211(b)(1)	8-21
1212	4-31
1212(a)(1)	8-24
1221	4-30, 8-7, 8-31, 8-45
1221(a)	8-4
1221(a)(2)	8-25
1221(b)(3)	8-4
1222(1)	2-6
1222(3)	8-13
1222(11)	4-30
1223	8-13
1223(1)	7-25, 9-23
1223(2)	7-13, 9-23
1223(4)	7-17
1223(5)	7-10, 10-21
1223(11)	7-16
1231	5-15, 7-25, 8-1, 8-2, 8-3, 8-5, 8-13, 8-14, 8-25, 8-26, 8-27, 8-28, 8-29, 8-30, 8-31, 8-32, 8-33, 8-34, 8-35, 8-36, 8-38, 8-39, 8-43, 8-44, 8-45, 9-22, 9-44, 11-12, 11-13, 11-16, 11-39, 12-32, 12-33, 15-22, 15-27, 15-29
1231(b)(1)	8-28
1231(c)	8-28
1233	8-15
1234(a)	8-9
1234(b)(1)	8-9

I.R.C. Sec.	This Work Page
1234A	8-8
1235	8-10
1236(a)	8-6
1236(b)	8-6
1237	8-6, 8-7, 8-40
1241	8-13
1244	1-21, 1-24, 6-1, 6-6, 6-7, 6-36, 6-37, 6-44, 8-2, 8-8, 12-5, 12-25, 12-35, 15-5, 15-14, 15-27, 15-29
1245	8-2, 8-3, 8-12, 8-29, 8-30, 8-31, 8-32, 8-33, 8-34, 8-35, 8-36, 8-37, 8-38, 8-39, 8-44, 8-46, 9-23, 15-22
1245(b)(1)	8-35
1245(b)(2)	8-36
1245(b)(3)	8-37, 9-23
1250	8-2, 8-3, 8-20, 8-18, 8-19, 8-22, 8-29, 8-31, 8-33, 8-34, 8-35, 8-36, 8-37, 8-38, 8-39, 8-46, 15-22
1250(d)(1)	8-35
1250(d)(2)	8-36
1250(d)(3)	8-37, 9-23
1253	8-11
1253(b)(1)	8-11
1259	8-15
1271	8-8
1272(a)(2)	4-12
1272(a)(3)	4-11
1273(a)	4-11
1361	15-3, 15-14
1361-1379	2-6, 12-2
1361(b)	12-5
1361(b)(1)(B)	12-6
1361(b)(1)(D)	12-6
1361(c)(1)(A)(ii)	12-6
1361(c)(1)(B)(i)	12-6
1361(c)(4)	12-6
1361(c)(5)(A)	12-6
1362	15-3
1362(a)(2)	12-8
1362(b)	12-7
1362(b)(1)(C)	12-7
1362(b)(5)	12-37
1362(d)	12-8
1362(d)(1)(B)	12-9
1362(d)(2)(B)	12-9
1362(d)(3)(A)(ii)	12-10
1362(d)(3)(B)	12-29
1362(d)(3)(C)	12-29
1362(e)(3)	12-9
1362(f)	12-37
1363	15-18
1363(b)	12-11
1366	15-18
1366(a)	12-11
1366(a)(1)	12-12
1366(b)	12-11
1366(c)	12-11
1366(d)	12-23
1366(e)	12-14, 15-21
1366(f)(2)	12-26
1367(a)	12-20
1367(b)(2)	12-21
1368(a)(1)(A)	12-22
1368(c)	12-16, 12-17
1368(c)(1)	12-16
1368(e)(1)	12-16
1368(e)(1)(A)	12-17, 12-22
1371(a)	2-37
1371(c)	12-18
1374	12-26
1374(d)(4)	12-29
1374(d)(7)	12-27
1374(d)(7)(B)	12-26
1375(a)	12-29
1375(b)	12-29
1377(a)	15-20
1377(a)(1)	12-12
1377(a)(2)	12-13
1377(b)	12-18
1402(a)	11-6, 11-32, 17-46
1402(a)(12)	17-44
1501-1504	3-4
1561(a)	9-32
1563(a)(1)	9-33
2010	1-10
2032(a)(1)	7-14
2032(c)	7-14
2503(a)	2-37
2503(g)(2)(A)	2-36
2505	1-10
3402	16-25
4942	5-15
6012(a)(1)	16-19
6012(a)(2)	9-34
6013(a)(1)	16-23
6013(g)	16-23
6017	17-43
6072(a)	16-20
6110	2-10
6654	16-25
6654(b)(2)	17-49
6654(b)(3)	17-49
6654(c)(1)	17-49
6655(d)	9-35
6655(e)	9-35
6662	2-11, 2-24
6712(a)	2-7
7701	13-18
7701(a)(1)	13-4
7701(a)(2)	11-5
7701(a)(4)	13-4
7701(a)(5)	13-4, 13-19
7701(b)	13-19
7702B	17-7
7805	2-7
7805(a)	2-9
7805(e)	2-9
7852(d)	2-7

I.R.C. Sec.	This Work Page
7872	4-39, 10-17
7872(a)(1)	4-19
7872(b)(2)	4-19
7872(c)	4-20
7872(c)(2)	4-21
7872(c)(3)	4-20
7872(d)	4-21
7872(d)(1)(B)	4-21
7872(f)(2)	4-19

Appendix D-2

TABLE OF REGULATIONS CITED

Temporary Treasury Regulations

Temp.Reg. Sec.	This Work Page
1.61-2T(j)	17-18
1.67-1T(a)(1)(iv)	17-51
1.117-6(b)(2)	16-33
1.117-6(c)(3)(i)	16-32
1.117-6(d)	17-11
1.117-6(h)	16-33
1.152-4T	16-16
1.248-1T(d)	9-30
1.274-5T(c)(3)	17-37
1.280F-6T(e)	5-33
1.469-1T(e)(3)(ii)	6-29
1.469-1T(g)(3)(i)(A)	6-28
1.469-1T(g)(3)(i)(B)	6-28
1.469-5T(a)	6-24
1.469-5T(b)(2)	6-27
1.469-5T(e)(3)(ii)	6-28
1.469-5T(f)(3)	6-27
1.469-5T(f)(4)	6-31
1.864(b)-1(b)(2)(ii)(E)	2-37

Treasury Regulations

Reg. Sec.	This Work Page
1.2	2-7, 2-8
1.61-1(a)	4-6
1.61-2(d)(2)(i)	7-8
1.61-3(a)	5-8
1.61-6(a)	7-6, 7-9

Treasury Regulations

Reg. Sec.	This Work Page
1.61-8(b)	8-13
1.61-9(c)	4-16
1.61-12	4-7
1.62-2(c)(4)	10-20
1.79-3(d)(2)	17-10
1.106-1	17-6
1.117-2(a)	16-32
1.118-1	9-24, 9-25
1.119-1(c)(1)	17-8
1.119-1(f)	17-9
1.132-1(b)	17-15
1.132-2	17-14
1.162-2(b)(1)	17-23
1.162-5(b)(2)	17-28
1.162-5(b)(3)	17-28
1.162-5(b)(3)(ii)	17-29
1.162-8	5-4
1.162-10	10-20
1.162-17(b)(4)	17-37
1.165-1(a)	7-6
1.165-1(d)(2)	6-8
1.165-1(d)(2)(i)	6-8
1.165-8(d)	6-8
1.165-8(a)(2)	6-8
1.165-9(b)(2)	7-17
1.166	6-3
1.166-1(e)	6-3
1.167(g)-1	7-13, 7-18
1.170A-4(b)(1)	8-36
1.170A-4A(b)(2)(ii)(C)	2-37
1.170A-10	16-50
1.174-2(a)(1)	5-17
1.183-1(b)(1)	17-51
1.183-2(b)(1) through (9)	17-50

Treasury Regulations

Reg. Sec.	This Work Page
1.199-5	11-18
1.199-5(b)(1)(i)	11-19
1.212-1(f)	17-28
1.213-1(e)(1)(iii)	16-38
1.263(a)-1(b)	5-9
1.263A-4(d)(4)(ii)	5-29
1.267(b)-1(b)(1)	2-25
1.274-4	17-24
1.280F-7(a)	5-35
1.301-1(j)	7-8, 10-16
1.301-1(m)	10-16
1.307-1(a)	7-10
1.312-6	10-4
1.312-6(a)	10-4
1.332-2(c)	10-25
1.351-1(a)(1)	9-11
1.351-1(a)(1)(ii)	9-11, 9-13, 9-14
1.351-1(a)(2)	2-7, 9-13
1.362-2(b)	9-25
1.381(b)-1(a)	2-32
1.408-10(b)	8-18
1.446-1(a)(2)	5-5
1.446-1(a)(3)	4-8
1.446-1(c)(1)(i)	4-8
1.446-1(c)(2)(i)	4-7
1.451-1(a)	4-10
1.451-2	4-8
1.451-2(a)	4-10
1.451-2(b)	4-11
1.451-5(b)	4-12
1.451-5(c)	4-12
1.453-9(c)(2)	9-10
1.461-1(a)	5-5
1.469-4	6-23
1.469-4(c)(3)	6-23
1.469-4(d)	6-23
1.469-4(f)	6-23
1.469-9	6-31
1.611-1(b)	5-37
1.672(b)-1	2-37
1.704-1(b)	11-20
1.731-1(c)(3)	11-10
1.752-1(a)	11-22
1.752-1(e)	12-21
1.1001-1(a)	7-3
1.1001-1(b)	7-3
1.1001-1(b)(2)	7-4
1.1001-1(c)(1)	7-3
1.1001-2(a)	4-26
1.1002-1(a)	7-6
1.1002-1(c)	7-18
1.1011-1	7-4, 7-13
1.1012-1(a)	7-8
1.1012-1(b)	7-4
1.1012-1(c)	7-42
1.1012-1(c)(1)	7-9
1.1015-1(a)(1)	7-11
1.1015-1(a)(3)	7-11
1.1015-5(c)(2)	7-12
1.1016-1	7-4
1.1016-3(a)(1)(i)	7-5
1.1016-5(a)	7-6
1.1016-5(b)	7-6
1.1016-6(a)	7-5
1.1031(a)-1(a)	7-20
1.1031(a)-1(b)	7-21
1.1031(d)-2	7-26
1.1032-1(a)	9-22
1.1033(a)-1	7-29
1.1033(a)-1(a)	7-28
1.1033(a)-2(a)	7-28
1.1033(a)-2(c)(3)	7-30
1.1091-1(a)	7-16
1.1091-1(c)	7-17
1.1091-1(f)	7-16
1.1091-2(a)	7-17
1.1221-1(b)	8-13
1.1223-1(a)	7-25
1.1223-1(b)	7-13
1.1223-1(d)	7-17
1.1223-1(e)	7-10
1.1234-1	8-45
1.1234-1(a)(1)	8-9
1.1235-2(b)(1)	8-10
1.1236-1(a)	8-6
1.1236-1(b)	8-6
1.1241-1(a)	8-13
1.1245-2(a)(4)	7-26, 8-37
1.1245-2(c)(2)	8-37
1.1245-4(a)(1)	8-35
1.1245-4(c)	8-37
1.1250-2(d)(1)	7-26
1.1250-3(a)(1)	8-35
1.1250-3(c)	8-37
1.1361-1(l)(2)	12-6
1.1361-1(l)(4)	12-6
1.1362-6(b)(3)(iii)	12-8
1.1367-1(f)	12-20
1.1367-2	12-22
1.1367-2(e)	12-21
1.1372-2(b)(1)	12-8
1.1373-1(a)	12-14
1.1377-1(a)(2)(ii)	12-12
1.6081-4	16-20
1.6661-3(b)(2)	2-24
20.2031-7(f)	2-37

Treasury Regulations

Reg. Sec.	This Work Page
31.3401(c)-(1)(b)	17-4
301.7701-1	9-8, 11-5, 15-3
301.7701-2	9-8, 11-5, 15-3
301.7701-3	9-8, 11-5, 15-3

Treasury Regulations

Reg. Sec.	This Work Page
301.7701-4	9-8, 15-3
301.7701-6	15-3
301.7701-7	9-8

Appendix D-3

TABLE OF REVENUE PROCEDURES AND REVENUE RULINGS CITED

Revenue Procedures

Rev.Proc.	This Work Page
75-28	2-37
77-37	9-14
87-56	5-24, 7-22, 10-5, 14-21
92-71	5-13
2002-28	4-9
2004-34	4-13
2005-50	2-37
2009-54	17-21
2010-1	2-10

Revenue Rulings

Rev.Rul.	This Work Page
54-96	9-12
56-60	7-14
56-406	7-16
57-418	5-11
59-44	2-25, 2-26
59-86	7-13
59-221	12-24
60-183	12-8
61-221	17-64
62-217	9-22
63-221	7-28
63-232	6-8
64-56	9-10
64-162	12-22

Revenue Rulings

Rev.Rul.	This Work Page
66-7	8-13
68-55	9-9
68-662	5-8
69-188	16-46
69-292	17-28
70-466	7-30
71-190	16-42
71-564	9-10
72-171	2-32
72-312	4-15
72-592	6-7
74-44	12-14
74-78	17-28
74-503	9-22
75-14	17-51
75-168	17-22
75-448	16-33
78-39	5-5
79-379	4-17
80-52	4-11
80-335	5-5
81-180	7-28
81-181	7-28
82-74	7-28
82-196	17-6
82-202	4-27
82-208	16-42
83-98	15-11
85-161	12-10
87-22	16-46
1997-2	12-37
2009-19	2-10, 4-14

Appendix E

TABLE OF CASES CITED

A

Addie, Donald, 2-17
Allen, Mary Francis, 6-8
Alpha Medical v. Comm., 10-16
Anderson, Comm. v., 17-9
Anglo-American Direct Tea Trading Co., 2-37
Anton, M. G., 4-17
Armantrout, Richard T., 16-33
Armstrong v. Phinney, 17-8
Artukovich, Nick A., 12-8
Ashtabula Bow Socket Co., 2-35
Augustus v. Comm., 2-22

B

Baist, George A., 17-29
Balistrieri, Joseph P., 7-28
Barry, Frederick J., 17-64
Bauer v. Comm., 9-27, 15-11
BB&T Corp., 2-35
Bedell v. Comm., 4-8
Bernal, Kathryn, 2-37
Bhalla, C. P., 16-32
Bingler v. Johnson, 16-32
Bissonnette, Marc G., 17-64
Bolker, Joseph R., 2-35
Bright v. U.S., 4-8
Brown v. Helvering, 4-10
Burnet v. Sanford and Brooks, 4-10
Burton-Sutton Oil Co., Inc., 2-34

C

Campbell, Jr. v. Wheeler, 9-16
Caruth Corporation v. U.S., 4-17
Cesarini v. U.S., 4-5
Choate Construction Co., 2-35
Comm. v. (see opposing party)
Commissioner v. Newman, 1-19
Correll, U.S. v., 17-22
Cowden v. Comm., 4-11
Crane v. Comm., 7-3
Craven, Linda, 2-37

D

Daly, D. R., Estate of, 4-24, 16-32
Davis, U.S. v., 7-4, 16-29
De Mendoza, III, Mario G., 12-25
Delman, Estate of v. Comm., 4-26
Delta Plastics, Inc., 9-27
Deputy v. DuPont, 5-3
DiZenzo v. Comm., 10-18
Doak, Comm. v., 17-8
Duberstein, Comm. v., 16-32, 16-47
Dunn and McCarthy, Inc. v. Comm., 5-3

E

Easson, Jack L., 9-16
Edwards v. Cuba Railroad Co., 9-24
Estate of (see name of party)

F

F. W. Woolworth Co., 2-8
Fahs v. Florida Machine and Foundry Co., 9-13
Fay v. Helvering, 6-8
Fin Hay Realty Co. v. U.S., 9-27, 10-16
Fischer, L. M., 4-11
Frank, Morton, 5-11

G

Glenshaw Glass Co., Comm. v., 4-5
Golsen, Jack E., 2-15
Guenther, Kenneth W., 17-32

H

Harolds Club v. Comm., 15-11
Hawkins, C. A., 16-34
Heininger, Comm. v., 5-3
Helvering v. (see opposing party)
Hempt Brothers, Inc. v. U.S., 9-10
Herbert C. Hayes, Inc., 2-34
Hertwig, U.S. v., 9-18

Houston, Michael J., 12-25
Hughes, Nick R., 2-16

J

Jacobson, Comm. v., 4-27
James O. Tomerlin Trust, 2-8
James v. U.S., 4-3

K

Kahler, Charles F., 4-8
Kai H. and Susanna Lee, 6-31
Kennedy, Jr. v. Comm., 5-3
Kieselbach v. Comm., 4-23
Kirby Lumber Co., U.S. v., 4-7, 4-27
Kluger Associates, Inc., 7-9
Knott, Henry J., 10-20
Kowalski, Comm. v., 17-8

L

Landfield Finance Co. v. U.S., 4-24
Lengsfield v. Comm., 10-15
Lincoln Electric Co., Comm. v., 5-3
Lindeman, J. B., 17-9
Loco Realty Co. v. Comm., 7-30
Lucas v. Earl, 4-13
Lucas v. North Texas Lumber Co., 4-10
Lucas v. Ox Fibre Brush Co., 2-35
Lynch v. Turrish, 7-3

M

Magneson, 2-35
Malat v. Riddell, 8-4
Mantell, John, 4-12
Marshman, Comm. v., 7-4
Mayson Manufacturing Co. v. Comm., 10-16, 15-11
McCandless Tile Service v. U.S., 10-20
McWilliams v. Comm., 7-16
Mead Corp., 2-37
Merchants Loan and Trust Co. v. Smietanka, 4-4
Miller, Harris M., 2-8
Mitnick, Moses, 17-23
Mixon, Jr., Estate of v. U.S., 9-27
Montgomery Engineering Co. v. U.S., 10-16
Mulherin, Brian C., 17-29

N

Nalle, George S., III v. Comm., 14-37
Nico, Severino R., Jr., 2-23
North American Oil Consolidated Co. v. Burnet, 4-10

O

O'Connor, John C., 9-13
O'Malley v. Ames, 7-4
O'Neill v. Sears, Roebuck & Co., 2-34

P

Page v. Rhode Island Trust Co., 5-5
Papineau, G. A., 17-8
Pauli, Karl, 2-16
Peranso, Dante and Sandi, 2-36
Pestcoe, William, 12-8
Pollock v. Farmer's Loan & Trust Co., 4-23
Portage Plastics Co. v. U.S., 12-10

R

R. J. Nicoll Co., 10-19
Radtke v. U.S., 12-14
Ramirez-Ota v. Comm., 2-37
Ray, John and Rochelle, 2-35
Reeves, Daniel L., 10-16
Riach v. Frank, 16-38
Rite Aid Corp., 2-34
Robertson v. U.S., 16-32
Rogers, U.S. v., 6-8
Rosenberg v. Comm., 6-8
Rowan Companies, Inc. v. U.S., 17-8

S

Sargent v. Comm., 4-14
Sauvigne, Donald J., 12-23
Schalk Chemical Co. v. Comm., 10-20
Selig, Bruce, 5-51
Sherman, Stephen G., 17-29
Shopmaker v. U.S., 6-8
Simon v. Comm., 10-18
Slappey Drive Industrial Park v. U.S., 9-27
Smith, Joe M., 12-22
Snow v. Comm., 5-17
Soliman, Comm. v., 17-34
Solomon, S. L., 6-8
South Carolina v. Baker III, 4-23
Spicer Accounting, Inc. v. U.S., 12-14
Strauss, Julia A., 4-8
Stubbs, Overbeck & Associates, Inc., 2-37
Sullivan, Comm. v., 5-8

T

T.H. Campbell & Bros., Inc., 12-7
Tank Truck Rentals, Inc. v. Comm., 5-7
Tauferner v. U.S., 17-21
Teleservice Co. of Wyoming Valley, 9-24
Tellier, Comm. v., 5-8
Thor Power Tool Co. v. Comm., 4-6
Tollis, Zane R., 8-45
Tomlinson v. 1661 Corp., 9-27
Tougher v. Comm., 17-8
Trinova Corp., 2-37
Tufts, Comm. v., 7-3
Turner v. U.S., 2-17
Tyler, W. David, 17-37

U

U.S. Trust Co. of New York v. Anderson, 4-23
Ulysses K. and Jane Lee, 6-31
United Draperies, Inc. v. Comm., 2-34
United States v. (see opposing party)
Untermann, John T., 2-37

V

Vincent, Nancy J., 2-37

W

Ward v. U.S., 12-7
Ward, Dwight A., 5-11
Welch v. Helvering, 5-3
Whitaker, William T., 17-37
Wilgard Realty Co. v. Comm., 9-12
Wilson, William B., 12-8
Wisconsin Cheeseman, Inc., The v. U.S., 5-14

Y

York v. Comm., 5-10

Appendix F

PRESENT VALUE AND FUTURE VALUE TABLES

Present Value of $1 F-2

Present Value of an Ordinary Annuity of $1 F-2

Future Value of $1 F-3

Future Value of an Ordinary Annuity of $1 F-3

Present Value of $1

N/R	4%	5%	6%	7%	8%	9%	10%	11%	12%	13%	14%
1	0.9615	0.9524	0.9434	0.9346	0.9259	0.9174	0.9091	0.9009	0.8929	0.8850	0.8772
2	0.9246	0.9070	0.8900	0.8734	0.8573	0.8417	0.8264	0.8116	0.7972	0.7831	0.7695
3	0.8890	0.8638	0.8396	0.8163	0.7938	0.7722	0.7513	0.7312	0.7118	0.6931	0.6750
4	0.8548	0.8227	0.7921	0.7629	0.7350	0.7084	0.6830	0.6587	0.6355	0.6133	0.5921
5	0.8219	0.7835	0.7473	0.7130	0.6806	0.6499	0.6209	0.5935	0.5674	0.5428	0.5194
6	0.7903	0.7462	0.7050	0.6663	0.6302	0.5963	0.5645	0.5346	0.5066	0.4803	0.4556
7	0.7599	0.7107	0.6651	0.6227	0.5835	0.5470	0.5132	0.4817	0.4523	0.4251	0.3996
8	0.7307	0.6768	0.6274	0.5820	0.5403	0.5019	0.4665	0.4339	0.4039	0.3762	0.3506
9	0.7026	0.6446	0.5919	0.5439	0.5002	0.4604	0.4241	0.3909	0.3606	0.3329	0.3075
10	0.6756	0.6139	0.5584	0.5083	0.4632	0.4224	0.3855	0.3522	0.3220	0.2946	0.2697
11	0.6496	0.5847	0.5268	0.4751	0.4289	0.3875	0.3505	0.3173	0.2875	0.2607	0.2366
12	0.6246	0.5568	0.4970	0.4440	0.3971	0.3555	0.3186	0.2858	0.2567	0.2307	0.2076
13	0.6006	0.5303	0.4688	0.4150	0.3677	0.3262	0.2897	0.2575	0.2292	0.2042	0.1821
14	0.5775	0.5051	0.4423	0.3878	0.3405	0.2992	0.2633	0.2320	0.2046	0.1807	0.1597
15	0.5553	0.4810	0.4173	0.3624	0.3152	0.2745	0.2394	0.2090	0.1827	0.1599	0.1401
16	0.5339	0.4581	0.3936	0.3387	0.2919	0.2519	0.2176	0.1883	0.1631	0.1415	0.1229
17	0.5134	0.4363	0.3714	0.3166	0.2703	0.2311	0.1978	0.1696	0.1456	0.1252	0.1078
18	0.4936	0.4155	0.3503	0.2959	0.2502	0.2120	0.1799	0.1528	0.1300	0.1108	0.0946
19	0.4746	0.3957	0.3305	0.2765	0.2317	0.1945	0.1635	0.1377	0.1161	0.0981	0.0829
20	0.4564	0.3769	0.3118	0.2584	0.2145	0.1784	0.1486	0.1240	0.1037	0.0868	0.0728

Present Value of an Ordinary Annuity of $1

N/R	4%	5%	6%	7%	8%	9%	10%	11%	12%	13%	14%
1	0.9615	0.9524	0.9434	0.9346	0.9259	0.9174	0.9091	0.9009	0.8929	0.8850	0.8772
2	1.8861	1.8594	1.8334	1.8080	1.7833	1.7591	1.7355	1.7125	1.6901	1.6681	1.6467
3	2.7751	2.7232	2.6730	2.6243	2.5771	2.5313	2.4869	2.4437	2.4018	2.3612	2.3216
4	3.6299	3.5460	3.4651	3.3872	3.3121	3.2397	3.1699	3.1024	3.0373	2.9745	2.9137
5	4.4518	4.3295	4.2124	4.1002	3.9927	3.8897	3.7908	3.6959	3.6048	3.5172	3.4331
6	5.2421	5.0757	4.9173	4.7665	4.6229	4.4859	4.3553	4.2305	4.1114	3.9975	3.8887
7	6.0021	5.7864	5.5824	5.3893	5.2064	5.0330	4.8684	4.7122	4.5638	4.4226	4.2883
8	6.7327	6.4632	6.2098	5.9713	5.7466	5.5348	5.3349	5.1461	4.9676	4.7988	4.6389
9	7.4353	7.1078	6.8017	6.5152	6.2469	5.9952	5.7590	5.5370	5.3282	5.1317	4.9464
10	8.1109	7.7217	7.3601	7.0236	6.7101	6.4177	6.1446	5.8892	5.6502	5.4262	5.2161
11	8.7605	8.3064	7.8869	7.4987	7.1390	6.8052	6.4951	6.2065	5.9377	5.6869	5.4527
12	9.3851	8.8633	8.3838	7.9427	7.5361	7.1607	6.8137	6.4924	6.1944	5.9176	5.6603
13	9.9856	9.3936	8.8527	8.3577	7.9038	7.4869	7.1034	6.7499	6.4235	6.1218	5.8424
14	10.5631	9.8986	9.2950	8.7455	8.2442	7.7862	7.3667	6.9819	6.6282	6.3025	6.0021
15	11.1184	10.3797	9.7122	9.1079	8.5595	8.0607	7.6061	7.1909	6.8109	6.4624	6.1422
16	11.6523	10.8378	10.1059	9.4466	8.8514	8.3126	7.8237	7.3792	6.9740	6.6039	6.2651
17	12.1657	11.2741	10.4773	9.7632	9.1216	8.5436	8.0216	7.5488	7.1196	6.7291	6.3729
18	12.6593	11.6896	10.8276	10.0591	9.3719	8.7556	8.2014	7.7016	7.2497	6.8399	6.4674
19	13.1339	12.0853	11.1581	10.3356	9.6036	8.9501	8.3649	7.8393	7.3658	6.9380	6.5504
20	13.5903	12.4622	11.4699	10.5940	9.8181	9.1285	8.5136	7.9633	7.4694	7.0248	6.6231

Future Value of $1

N/R	4%	5%	6%	7%	8%	9%	10%	11%	12%	13%	14%
1	1.0400	1.0500	1.0600	1.0700	1.0800	1.0900	1.1000	1.1100	1.1200	1.1300	1.1400
2	1.0816	1.1025	1.1236	1.1449	1.1664	1.1881	1.2100	1.2321	1.2544	1.2769	1.2996
3	1.1249	1.1576	1.1910	1.2250	1.2597	1.2950	1.3310	1.3676	1.4049	1.4429	1.4815
4	1.1699	1.2155	1.2625	1.3108	1.3605	1.4116	1.4641	1.5181	1.5735	1.6305	1.6890
5	1.2167	1.2763	1.3382	1.4026	1.4693	1.5386	1.6105	1.6851	1.7623	1.8424	1.9254
6	1.2653	1.3401	1.4185	1.5007	1.5869	1.6771	1.7716	1.8704	1.9738	2.0820	2.1950
7	1.3159	1.4071	1.5036	1.6058	1.7138	1.8280	1.9487	2.0762	2.2107	2.3526	2.5023
8	1.3686	1.4775	1.5938	1.7182	1.8509	1.9926	2.1436	2.3045	2.4760	2.6584	2.8526
9	1.4233	1.5513	1.6895	1.8385	1.9990	2.1719	2.3579	2.5580	2.7731	3.0040	3.2519
10	1.4802	1.6289	1.7908	1.9672	2.1589	2.3674	2.5937	2.8394	3.1058	3.3946	3.7072
11	1.5395	1.7103	1.8983	2.1049	2.3316	2.5804	2.8531	3.1518	3.4785	3.8359	4.2262
12	1.6010	1.7959	2.0122	2.2522	2.5182	2.8127	3.1384	3.4985	3.8960	4.3345	4.8179
13	1.6651	1.8856	2.1329	2.4098	2.7196	3.0658	3.4523	3.8833	4.3635	4.8980	5.4924
14	1.7317	1.9799	2.2609	2.5785	2.9372	3.3417	3.7975	4.3104	4.8871	5.5348	6.2613
15	1.8009	2.0789	2.3966	2.7590	3.1722	3.6425	4.1772	4.7846	5.4736	6.2543	7.1379
16	1.8730	2.1829	2.5404	2.9522	3.4259	3.9703	4.5950	5.3109	6.1304	7.0673	8.1372
17	1.9479	2.2920	2.6928	3.1588	3.7000	4.3276	5.0545	5.8951	6.8660	7.9861	9.2765
18	2.0258	2.4066	2.8543	3.3799	3.9960	4.7171	5.5599	6.5436	7.6900	9.0243	10.5752
19	2.1068	2.5270	3.0256	3.6165	4.3157	5.1417	6.1159	7.2633	8.6128	10.1974	12.0557
20	2.1911	2.6533	3.2071	3.8697	4.6610	5.6044	6.7275	8.0623	9.6463	11.5231	13.7435

Future Value of an Ordinary Annuity of $1

N/R	4%	5%	6%	7%	8%	9%	10%	11%	12%	13%	14%
1	1.0000	1.0000	1.0000	1.0000	1.0000	1.0000	1.0000	1.0000	1.0000	1.0000	1.0000
2	2.0400	2.0500	2.0600	2.0700	2.0800	2.0900	2.1000	2.1100	2.1200	2.1300	2.1400
3	3.1216	3.1525	3.1836	3.2149	3.2464	3.2781	3.3100	3.3421	3.3744	3.4069	3.4396
4	4.2465	4.3101	4.3746	4.4399	4.5061	4.5731	4.6410	4.7097	4.7793	4.8498	4.9211
5	5.4163	5.5256	5.6371	5.7507	5.8666	5.9847	6.1051	6.2278	6.3528	6.4803	6.6101
6	6.6330	6.8019	6.9753	7.1533	7.3359	7.5233	7.7156	7.9129	8.1152	8.3227	8.5355
7	7.8983	8.1420	8.3938	8.6540	8.9228	9.2004	9.4872	9.7833	10.0890	10.4047	10.7305
8	9.2142	9.5491	9.8975	10.2598	10.6366	11.0285	11.4359	11.8594	12.2997	12.7573	13.2328
9	10.5828	11.0266	11.4913	11.9780	12.4876	13.0210	13.5795	14.1640	14.7757	15.4157	16.0853
10	12.0061	12.5779	13.1808	13.8164	14.4866	15.1929	15.9374	16.7220	17.5487	18.4197	19.3373
11	13.4864	14.2068	14.9716	15.7836	16.6455	17.5603	18.5312	19.5614	20.6546	21.8143	23.0445
12	15.0258	15.9171	16.8699	17.8885	18.9771	20.1407	21.3843	22.7132	24.1331	25.6502	27.2707
13	16.6268	17.7130	18.8821	20.1406	21.4953	22.9534	24.5227	26.2116	28.0291	29.9847	32.0887
14	18.2919	19.5986	21.0151	22.5505	24.2149	26.0192	27.9750	30.0949	32.3926	34.8827	35.5811
15	20.0236	21.5786	23.2760	25.1290	27.1521	29.3609	31.7725	34.4054	37.2797	40.4175	43.8424
16	21.8245	23.6575	25.6725	27.8881	30.3243	33.0034	35.9497	39.1899	42.7533	46.6717	50.9804
17	23.6975	25.8404	28.2129	30.8402	33.7502	36.9737	40.5447	44.5008	48.8837	53.7391	59.1176
18	25.6454	28.1324	30.9057	33.9990	37.4502	41.3013	45.5992	50.3959	55.7497	61.7251	68.3941
19	27.6712	30.5390	33.7600	37.3790	41.4463	46.0185	51.1591	56.9395	63.4397	70.7494	78.9692
20	29.7781	33.0660	36.7856	40.9955	45.7620	51.1601	57.2750	64.2028	72.0524	80.9468	91.0249

Index

A

AAA bypass election, **12**:16
Abandoned spouse rules, **16**:23
Abode test for qualifying child, **16**:12
Accelerated cost recovery system (ACRS), **5**:22
Accident and health insurance benefits, **16**:35
Accident and health plans, employer-sponsored, **17**:6
Accountable plan, **17**:4, **17**:37
Accounting concepts of income, **4**:4–5
  and tax concepts of income, comparison of, **4**:6
Accounting data, flow of, **3**:4
Accounting for Contingencies, FAS 5, **3**:17
Accounting for Uncertainty in Income Taxes, FIN 48, **3**:17
Accounting income, **4**:5
Accounting method, **4**:7–10, **17**:48
  adjustments, **10**:5
  prescribed by IRS, **4**:7
  See also Accrual method; Cash receipts and disbursements method; Cash receipts method; Completed contract method; Hybrid method; Installment method; Percentage of completion method
Accounting periods, **17**:48
Accounts and notes receivable, definition of capital asset, **8**:4, **8**:5
Accrual basis corporation exception, **1**:22, **5**:14
Accrual basis taxpayers, special rules for, **4**:12–13
  deferral of advance payments for goods, **4**:12
  deferral of advance payments for services, **4**:13
  prepaid income, **4**:12
Accrual method, **4**:7, **4**:10
  requirements, **5**:6
Accrued income and expenses, **3**:6
Accumulated adjustments account (AAA), **12**:16–17, **12**:18
  adjustments to corporate, **12**:17
Accumulated E & P (AEP), **10**:4
  chronological order allocation of, **10**:7
  S corporation with, **12**:15–16
  S corporation with no, **12**:15
Accumulated earnings tax, **10**:26
Acquiescence (A or Acq.), **2**:16
Acquisition indebtedness, **16**:45
Action on Decision, **2**:16, **2**:23
Active income, **6**:16, **6**:18
Active participant, phaseout of IRA deduction of, **17**:39
Active participation, **6**:32
Ad valorem taxes, **1**:11, **16**:41
Additional depreciation, **8**:33
Additional first-year depreciation, **5**:26
Additional standard deduction, **16**:8–9
Adjusted basis, **4**:30, **7**:4
Adjusted current earnings (ACE), **14**:25–27
  AMT in C corporations, **15**:10
  impact of various transactions on, **14**:26
Adjusted gain or loss, **14**:21–23
Adjusted gross income (AGI), **16**:6–7
  See also Deductions for AGI; Deductions from AGI
Adjustments
  planning strategies for controlling the timing of preferences and, **14**:28
  summary of basis, **7**:18
  summary of E & P, **10**:7
  to basis, **7**:19
Administrative pronouncements, other, **2**:11
Administrative sources of tax law, **2**:7–11
  assessing the significance of other, **2**:23
  letter rulings, **2**:10
  other administrative pronouncements, **2**:11
  revenue rulings and revenue procedures, **2**:9–10
  treasury department regulations, **2**:7–9
Adoption expenses credit, **16**:53–54
ADS. *See* Alternative depreciation system
Advance payments for services, deferral of, **4**:13
Age 65 or over, additional standard deduction, **16**:8
Age test for qualifying child, **16**:12
Agent, income received by, **4**:17
Alimony and separate maintenance payments, **16**:29–30
  child support, **16**:30
All events text, **5**:6
Allocate, **13**:25
Allocation problems, cost basis, **7**:9–11
Alternate valuation amount, **7**:14
Alternative depreciation system (ADS), **5**:25, **5**:36, **10**:5, **14**:19–21
  cost recovery tables, **5**:43–44
  straight-line method, **5**:29
Alternative minimum tax (AMT), **14**:13, **15**:9–10
  and regular corporate income tax rate difference, planning strategies for the optimum use of, **14**:28
  base, **14**:28
  corporate, **14**:13–29
    adjusted current earnings (ACE), **14**:25–27
    AMT adjustments, **14**:18–24
    AMT formula, **14**:15–16
    computing AMTI, **14**:27–28
    minimum tax credit, **14**:28–29
    other aspects of, **14**:29
    rate and exemption, **14**:28
    tax preferences, **14**:16–18
    who pays, **15**:11
  exemption, **9**:32, **14**:13, **14**:28
  individual, **14**:29–30
  planning strategies for, **15**:10
  reach of, **14**:17
Alternative minimum taxable income (AMTI), **14**:15
  computing, **14**:27–28
American Depository Receipts (ADRs), trading on U.S. stock exchanges, **8**:14
American Federal Tax Reports (AFTR), **2**:17
American Jobs Creation Act of 2004, **5**:20
American Opportunity credit, **16**:56, **16**:57, **17**:31, **17**:42
American Recovery and Reinvestment Tax Act (ARRTA) of 2009, **2**:3, **2**:5, **6**:15, **5**:26, **9**:25, **16**:9, **16**:31, **16**:43, **16**:58, **16**:59, **17**:17
Americans with Disabilities Act, **14**:2
Amortizable bond premium, capital recoveries, **7**:6
Amortizable Section 197 intangible, **5**:36
Amortization, **5**:36–37
  method of research and experimental expenditures, **5**:18
  of intangible assets, **5**:22
Amount realized, **4**:30, **7**:3–4
AMT adjustments
  adjusted gain or loss, **14**:21–23
  computing, **14**:18–19
  depreciation of post-1986 personal property, **14**:20–21
  depreciation of post-1986 real property, **14**:19–20
  passive activity losses, **14**:23–24
  planning strategies for avoiding, **14**:24

AMT adjustments *(contd.)*
pollution control facilities, **14**:21
use of completed contract method of accounting, **14**:21
AMT exemption
initial test for corporations, **14**:13
ongoing test for corporations, **14**:13
related corporations, **9**:32
Annual accounting period concept, **1**:31
Annual exclusion, gift tax, **1**:10
Annual limitations of election to expense assets under Section 179, **5**:31–32
Antitrust law violations, **5**:7
APB 23, **3**:4
Appeals, **2**:13
Appellant, **2**:24
Appellate courts, **2**:13–15
Appellee, **2**:24
Apportioned, **13**:25
Appreciated property, **7**:24
Appreciated securities, planning strategies for gifts of, **8**:17
Appropriate economic unit, **6**:23
Arm's length price, **13**:17
ARRTA. *See* American Recovery and Reinvestment Tax Act of 2009
ASC 740 (SFAS 109), **3**:9–11, **3**:13–14, **3**:16–17
ASC 740-10 (FIN 48), **3**:17
ASC 740-30 (APB 23), **3**:17–18
planning strategies for reducing effective tax rates with, **3**:19
ASC Topic 740, **3**:4
Asset Depreciation Range (ADR), **10**:5
Assets
classification and use of, **1**:12
election to expense under Section 179, **5**:31–32
fixed, **3**:6, **8**:5, **8**:25
in a lump-sum purchase, allocation of, **7**:9
intangible, **3**:6, **5**:22, **11**:12
of partnerships, tax year 2007, **11**:21
personal-use, **5**:23, **7**:7, **8**:4
planning strategies for selling, **15**:24
Section 1231, **8**:3, **8**:25–29
tainted, **9**:15
transfer of to business entity, **7**:31
write-off of tangible, **5**:22
Assignment of income, **4**:14
Associated with business, **17**:32
Assumption of liabilities, **9**:15–17
exceptions, **9**:15–16, **9**:16–17
At-risk amount, calculation of, **6**:18
At-risk and passive activity limits, interaction of, **6**:29–30
At-risk limitation, **6**:15, **6**:16–18, **11**:26, **11**:28–29
At-risk rules, **12**:24
effect of, **15**:19–20
Audit roadmap expands, **3**:6
Auto sales taxes standard deductions, **16**:9
Automatic mileage method, **17**:21
Automobiles
business and personal use of, **5**:32–36
change from predominantly business use, **5**:35
computation of expenses, **17**:21
inclusion amount in gross income for leased, **5**:35
limits on cost recovery, **5**:33–34
not used predominantly in business, **5**:35
passenger, **5**:33
special limitation, **5**:34
used predominantly in business, **5**:33
Average rate, **16**:24
Average tax rate, **1**:26
Awards, prizes and, **16**:30–31
Away-from-home requirement, **17**:22

B

Backdoor tax increase, **1**:11
Bad debts, **6**:3–6
business vs. nonbusiness, **6**:4–5
loans between related parties, **6**:5–6
specific charge-off method, **6**:3–4, **6**:5
Bailout paid big dividends, **10**:8
Balance sheet approach, **3**:10
Bankruptcy, **2**:13, **6**:4
insolvency and, **4**:27–28
one way to avoid, **4**:29
worthless stock and, **8**:8
Bargain purchase of property, **7**:8
Bargain rental of corporate property, **10**:16
Bargain sale of corporate property to a shareholder, **10**:16
Bases, inside and outside, **11**:13
Basic research, **14**:10
expenditures, **14**:10
Basic standard deduction, **16**:8–9
Basis
adjusted, **7**:4
adjustments to, **7**:19
and holding period of property received, **7**:25–26
carryover, **7**:11
determination of cost, **7**:8–11
election to expense assets under Section 179, effect on, **5**:32
liabilities in excess, **9**:16–17
of boot, **7**:25
of like-kind property, **7**:25
of ownership interest, effect on, **15**:16–17
of property to corporation, **9**:19–20
of stock to shareholder, **9**:18–19
shareholder's, **12**:20–22
stepped-down, **7**:14
stepped-up, **7**:14
Basis adjustment for loss property, **9**:20–22
Basis adjustments, summary of, **7**:18
Basis computation, partnership formation and, **11**:14
Basis considerations, **7**:8–18
conversion of property from personal use to business or income-producing use, **7**:17–18
determination of cost basis, **7**:8–11
disallowed losses, **7**:16–17
gift basis, **7**:11–14
property acquired from a decedent, **7**:14–16
summary of basis adjustments, **7**:18
Basis determination and other issues, **9**:18–23
basis adjustment for loss property, **9**:20–22
basis of property to corporation, **9**:19–20
basis of stock to shareholder, **9**:18–19
holding period for shareholder and transferee corporation, **9**:22–23
stock issued for services rendered, **9**:22
Basis for depreciation, **7**:13–14
converted property, **7**:18
Basis in the partnership interest, **11**:9
Basis limitation, **11**:26–28
Basis of a partnership interest, **11**:21–23
partner's basis, gain and loss, **11**:23–26
partnership liabilities, **11**:22–23
Baskets (separate foreign tax credit limitation categories), **13**:13
Below-market loans
effect of certain on the lender and borrower, **4**:20
exceptions to imputed interest rules for, **4**:21
imputed interest on, **4**:19–22
Benchmarking, **3**:26–29
Benefit received rule, **16**:47
Benefits
general classes of excluded, **17**:13–18
general classes of fringe, **17**:20
taxable fringe, **17**:18
Bequests and inheritances, **16**:32
Blind, additional standard deduction, **16**:8
Bond Market Association, **14**:18
Bonds
distinguishing between taxable and exempt for AMT purposes, **14**:18
planning strategies for state and municipal, **4**:23–24
Book vs. tax, **3**:8
Book-tax
differences, **3**:3–8
expense, steps in determining, **3**:21
income gap, **3**:9
Boot, **7**:24–25, **9**:9, **9**:11, **9**:18
basis of, **7**:25
giving of, **7**:24
receipt of, **7**:24
Bracket creep, **1**:31
Bribes, **5**:7
Brokers to provide cost basis data, **7**:9
Built-in gain or loss, **11**:20
Built-in gains tax, **12**:26
calculation of liability, **12**:26
general rules, **12**:26–27
LIFO recapture tax, **12**:28
planning strategies for, **12**:27
Built-in loss property, **9**:20
Business
disposition of, **15**:21–25
investigation of, **5**:10–11
planning strategies for the sale of, **5**:37
planning strategies when incorporating, **9**:23
vs. nonbusiness bad debts, **6**:4–5
Business activities, deductions for AGI, **1**:15
Business and personal use of automobiles and other listed property, **5**:32–36
change from predominantly business use, **5**:35
leased automobiles, **5**:35
limits on cost recovery for automobiles, **5**:33–34
not used predominantly in business, **5**:35
special limitation, **5**:34

substantiation requirements, **5**:36
used predominantly in business, **5**:33
Business bad debt, **6**:4–5
Business cycle, economics and, **5**:32
Business debt, **6**:3
Business decisions, role of taxes in, **1**:2
Business deductions
common, **5**:4
ordinary and necessary requirement, **5**:3
overview of, **5**:3–4
partial list of, **5**:4
reasonableness requirement, **5**:3–4
Business depreciable equipment, **8**:32
Business entities, **15**:3–5
conduit vs. entity treatment, **15**:15–21
disposition of a business or an ownership interest, **15**:21–25
federal tax consequences, **11**:3–4
income taxation of, **1**:17–19
minimizing double taxation, **15**:11–15
nontax factors, **15**:5–7
overall comparison of forms of doing business, **15**:25–30
planning strategies for choosing, **15**:31
principal forms of, **15**:3–4
single vs. double taxation, **15**:7–10
tax attributes of different forms of business, **15**:27–30
tax treatment of disposition, **15**:25–26
transfer of assets to, **7**:31
See also C corporations; Closely held C corporations; Corporations; Limited liability company; Limited liability entities; Limited liability partnership; Partnership; Proprietorship; S corporations; Sole proprietorship
Business expenses, Schedule C of Form 1040, **16**:47
Business fixed assets, definition of capital asset, **8**:4, **8**:5
Business gifts, **17**:33
Business income and loss, **4**:17
Business law
business entity, **15**:8
employee or independent contractor, **17**:3
income tax laws, **2**:20
partnership agreement, **11**:20
S corporation, **12**:4
Business meals, restrictions upon deductibility of, **17**:33
Business property
losses, **6**:7
complete destruction of, **6**:10
partial destruction of, **6**:10
Business supplies, definition of capital asset, **8**:4
Business-related tax credit provisions, **14**:3–13
Business-use realty, **1**:12
Buyback rules, **9**:25
Buy-sell agreements, **4**:25

C

C corporations, **1**:18, **9**:3, **11**:3, **15**:3–4
disposition of, **12**:19, **15**:24, **15**:25–26
Form 1120, **1**:18, **11**:16
LLC advantages over, **15**:4
tax attributes of, **15**:27–30
See also Business entities; Corporations
Cafeteria plans, **17**:12–13
Calendar year, **4**:7
Capital account, **11**:8
Capital additions, **7**:4–5
Capital assets, **8**:3–7
definition of, **8**:3–6
long-term nonpersonal-use, **8**:26
Section 1231 assets relationship to, **8**:25
statutory expansions, **8**:6–7
Capital changes, partner's basis, gain and loss, **11**:25–26
Capital contributions, **9**:24–25
Capital distributions, return of, **15**:13
Capital expenditures, **16**:38–39
disallowance of deductions for, **5**:9–10
Capital formation, business entities, **15**:5–6
Capital gain property, **5**:15, **16**:50
Capital gains, **4**:30–31, **8**:3, **8**:16–19
for wealthy, **8**:24
individual returns reporting, **8**:17
long-term gains, **8**:16–19
of corporate taxpayers, tax treatment of, **8**:24–25
of noncorporate taxpayers, tax treatment of, **8**:16–19
planning strategies for the timing of, **8**:16
rates, **8**:32
rationale for separate reporting of, **8**:3
short-term gains, **8**:16
treatment in the U.S. and other countries, **8**:18
Capital interest, **11**:8
Capital loss deduction, **8**:20
Capital losses, **4**:30–31, **8**:3, **8**:16, **8**:19–22
detrimental tax treatment of, **8**:21
of corporate taxpayers, tax treatment of, **8**:24–25
of noncorporate taxpayers, tax treatment of, **8**:19–22
rationale for separate reporting of, **8**:3
short-term, nonbusiness bad debt, **6**:5
Capital recoveries, **7**:4–6
Capital restructuring results in redemption of 102 million shares, **10**:23
Capital sharing ratio, **11**:8
Capital structure of a corporation, **9**:24–27
capital contributions, **9**:24–25
debt in the capital structure, **9**:25–27
Capitalization vs. expense, **5**:10
Carryback and carryover periods, **6**:13–14
election to forgo carryback of NOL, **6**:14
NOLs from multiple tax years, **6**:14
Carrybacks, limited relief under the stimulus bill for, **6**:15
Carryover basis, **7**:11, **11**:11
Carryover of another taxpayer's basis, nontaxable transactions involving, **8**:14
Cash basis taxpayers, special rules for, **4**:10–12
amounts received under an obligation to repay, **4**:12
constructive receipt, **4**:10–11
original issue discount, **4**:11–12
Cash meal allowance, **17**:8
Cash method requirements, **5**:5
Cash receipts and disbursements method, **4**:7
Cash receipts method, **4**:8–9
Casualties, capital recoveries, **7**:5
Casualty gain, **6**:8, **6**:11
Casualty loss limits, proposal for changing, **6**:13
Casualty losses, **6**:7–12
deductible from AGI, **8**:27
definition of casualty, **6**:7–8
individual, **6**:11–12
measuring the amount of loss, **6**:9–11
planning strategies for documentation of, **6**:9
when to deduct, **6**:8–9
Casualty netting, general procedure for Section 1231 computation, **8**:27
Casualty or theft and nonpersonal-use capital assets, Section 1231 assets, **8**:26
Centralized management, **9**:7
Change in form not in substance, **7**:18
Charitable contributions, **5**:14–17, **16**:47–52
benefit received rule, **16**:47
contribution carryovers, **16**:51–52
contribution of services, **16**:48
criteria for a gift, **16**:47
fifty percent ceiling, **16**:50
Form 8283, Noncash Charitable Contributions, **16**:49
limitations imposed on, **5**:16–17
limitations on deduction, **16**:50
nondeductible items, **16**:48
property contributions, **5**:15–16
record-keeping requirements, **16**:49
thirty percent ceiling, **16**:50–51
time of deduction, **16**:49
twenty percent ceiling, **16**:51
valuation requirements, **16**:49
Charitable transfers, recapture potential of, **8**:36–37
Check-the-box, **13**:18
rules, **15**:3
Check-the-box Regulations, **9**:8
related groups planning strategies, **9**:8
Child and dependent care expenses, credit for, **16**:54–56
calculation of, **16**:55–56
earned income ceiling, **16**:55
eligibility for, **16**:55
eligible employment-related expenses, **16**:55
Child care resource and referral services, **14**:11
Child support, **16**:30
Child tax credit, **16**:54
maximum credit and phaseouts, **16**:54
Children of divorced or separated parents, multiple support agreement and, **16**:16
Children taxed at parent's rate
election to report certain unearned income on parent's return, **16**:27–28
net unearned income of, **16**:27
unearned income of, **16**:26–28
Chronological order allocation of accumulated E & P, **10**:7
Circuit Court of Appeals, **2**:13–15
Circular 230, **2**:31

Circulation expenditures, AMT adjustments for, **14**:15
Citizens for Tax Justice, **3**:9
Citizenship or residency test for dependency exemptions, **16**:17
Claim of right doctrine, **4**:10
  miscellaneous itemized deduction for repayment of amounts under, **16**:52
Claims Court Reporter (Cl.Ct.), **2**:17
Clawback provision, **15**:17
  executive compensation, **5**:10
Client letter, **2**:27
Closely held C corporation, **6**:22–23, **15**:19
  See also Business entities; Corporations
Club dues, restrictions upon deductibility of, **17**:33
Collectibles, **8**:18
Combined return of a unitary business, **13**:28
Committee Reports, **2**:5
Commodities options, **8**:9
Commodity futures options, **8**:9
Common business deductions, **5**:4
Common law system, **1**:32
  joint filing status, **16**:21–22
Community property system, **1**:32
  joint filing status, **16**:21–22
Commuter highway vehicle, **17**:17
Commuting expenses, **17**:21
Compensation
  disguised, **16**:33
  Stock Compensation ASC Topic 718-10, FASB, **3**:5
  unemployment, **16**:31
  unreasonable, **5**:4, **15**:12
  workers', **16**:34
Compensation czar, **5**:10
Compensation-related expenses, **3**:6
Compensation-related loans, imputed interest rules, **4**:20
Compensatory damages, **16**:33
Completed contract method, **4**:7
  use of in AMT adjustments, **14**:21
Condemnation gains and losses, **8**:26
Conduit approach, partnerships, **15**:15–16
Conduit concept, **15**:15
  partnerships, limited liability entities, and S corporations, **15**:18
Conduit vs. entity treatment, **15**:15–21
  effect of at-risk rules, **15**:19–20
  effect of special allocations, **15**:20–21
  effect on basis of ownership interest, **15**:16–17
  effect on passive activity losses, **15**:19
  effect on recognition at time of contribution to the entity, **15**:15–16
  effect on recognition at time of distribution, **15**:18–19
  effect on results of operations, **15**:17–18
Conference Committee, **2**:4–5
Congress, intent of, **2**:5
Congressional Budget Office, **1**:3
Conservatism principle, **3**:13
Constructive dividend, **10**:15–20
  bargain rental of corporate property, **10**:16
  bargain sale of corporate property to a shareholder, **10**:16
  loans to a corporation by shareholders, **10**:18
  loans to shareholders, **10**:16–17
  payments for the benefit of a shareholder, **10**:16
  planning strategies for, **10**:19–20, **13**:18
  shareholder use of corporate-owned property, **10**:15–16
  tax treatment of, **10**:18
  types of, **10**:15–18
  unreasonable compensation, **10**:16
Constructive ownership provisions, **5**:12
  in transactions between related parties, **5**:12–13
Constructive receipt, **4**:10–11
  problems, lottery winners and, **4**:12
Constructive sale treatment, short sales, **8**:15
Contingent payments, **8**:12
Continuity of life, **9**:7
Contributed property, tax issues related to, **11**:11–13
  depreciation method and period, **11**:12
  intangible assets, **11**:12
  receivables, inventory, and losses, **11**:12–13
Contribution carryovers, **16**:51–52
Contribution of services, **16**:48
Contribution to the entity, effect on recognition at time of, **15**:15–16
Contributions of property by individuals, determining the deduction for, **16**:51
Control, **9**:11
Control of the corporations, **9**:11–15
  immediately after the transfer, **9**:11–12
  transfers for property and services, **9**:13
  transfers for services and nominal property, **9**:13–14
  transfers to existing corporations, **9**:14–15
Controlled corporations, organization of and transfers to, **9**:8–23
  assumption of liabilities—Section 357, **9**:15–17
  basis determination and other issues, **9**:18–23
  control immediately after the transfer, **9**:11–12
  control of the corporations, **9**:11–15
  recapture considerations, **9**:23
  stock, **9**:11
  transfer of property, **9**:10–11
  transfers for property and services, **9**:13
  transfers for services and nominal property, **9**:13–14
  transfers to existing corporations, **9**:14–15
Controlled foreign corporations (CFCs), **13**:14–18
Controlled group, **9**:33–34
  application of Section 482, **9**:34
  parent-subsidiary controlled group, **9**:33
  parent-subsidiary corporations, **9**:33, **9**:34
Convenience of the employer test, **17**:9
Conversion of property from personal use to business or income-producing use, **7**:17–18
Copyrights
  definition of capital asset, **8**:4, **8**:5–6
  Section 197 intangible, **5**:37
Corporate accumulations, restrictions on, **10**:26
Corporate AMT, who pays, **15**:11
Corporate assets vs. stock, planning strategies for selling, **15**:9
Corporate distributions
  capital recoveries, **7**:6
  planning strategies for, **10**:11
Corporate federal income tax, who pays, **15**:12
Corporate income
  double taxation of, **9**:3–5
  tax liability, determining the, **9**:31–32
  tax rates, **9**:31–32
Corporate liquidations, **10**:24–26
Corporate multistate income taxation, **13**:29
Corporate obligations, retirement of, **8**:8
Corporate operations, **9**:28–34
  controlled groups, **9**:33–34
  deductions available only to corporations, **9**:28–31
  determining the corporate income tax liability, **9**:31–32
  tax liability of related corporations, **9**:32–33
Corporate tax, **9**:3–8
  comparison of corporations and other forms of doing business, **9**:5–7
  double taxation of corporate income, **9**:3–5
  entity classification, **9**:8
  limited liability companies, **9**:7–8
  nontax considerations, **9**:7
Corporate taxpayers, tax treatment of capital gains and losses of, **8**:24–25
Corporate-level tax, **12**:26
Corporate-owned life insurance, **4**:25
Corporations, **1**:18, **15**:3–4
  additional recapture for, **8**:35
  AMT formula for, **14**:16
  and other forms of doing business, comparison of, **9**:5–7
  basis in property received, **9**:20
  capital structure of, **9**:24–27
  effect of property dividends on, **10**:13–15
  entity approach, **15**:16
  filing requirements for, **9**:34
  Form 1120, **15**:4
  overseas branch operation, **9**:3
  overseas subsidiary, **9**:3
  reporting responsibilities, **9**:4
  tax consequences to, with and without the application of Section 351, **9**:20
  transfers to existing, **9**:14–15
Corporation-shareholder loans, imputed interest rules, **4**:20
Cosmetic surgery, **16**:38
Cost accounting and executive compensation, **13**:32
Cost basis data, brokers to provide, **7**:9
Cost basis, determination of, **7**:8–11
  allocation problems, **7**:9–11
  identification problems, **7**:9
Cost depletion, **5**:38–39
Cost method, **3**:3
Cost of repairs, **6**:10
Cost recovery allowances, **5**:22–36
  alternative depreciation system (ADS), **5**:36
  business and personal use of automobiles and other listed property, **5**:32–36

concepts relating to depreciation, **5**:23–24
cost recovery for personal property, **5**:24–28
cost recovery for real estate, **5**:28
depreciation and, **7**:5
election to expense assets under Section 179, **5**:31–32
farm property, **5**:29–30
leasehold improvement property, **5**:30–31
modified accelerated cost recovery system (MACRS), **5**:24
straight-line election, **5**:29
Cost recovery allowed or allowable, **5**:23–24
Cost recovery basis for personal-use assets converted to business or income-producing use, **5**:24
Cost recovery by any other name, **5**:22
Cost recovery periods
for farming assets, **5**:30
MACRS personalty, **5**:25
Cost recovery recapture, **5**:35
Cost recovery tables, **5**:40–44
Costs
of complexity of tax system, **1**:34
organizational, **11**:15
start-up, **11**:15–16
Courts
appellate, **2**:13–15
Court of Appeals, **2**:13–15
judicial citations of, **2**:17
Court of Federal Claims, **2**:1, **2**:12–13, **2**:13–15
judicial citations of, **2**:17
jurisdiction of, **2**:13
Court of original jurisdiction, **2**:11
District Courts, **2**:11, **2**:12–13, **2**:13–15
judicial citations of, **2**:17
jurisdiction of, **2**:13
influence of
judicial concepts relating to tax, **1**:34–35
judicial influence on statutory provisions, **1**:35
on tax law, **1**:34–35
of original jurisdiction, **2**:12–13
Supreme Court, **2**:15
judicial citations of, **2**:18
Tax Court, **2**:11, **2**:12–13, **2**:13–15
judicial citations of, **2**:16–17
jurisdiction of, **2**:13
Small Cases Division of, **2**:11
trial, **2**:12–13
Covenants not to compete, Section 197 intangible, **5**:37
Coverdell Education Savings Account (CESA), **16**:58, **17**:41–42
CPA examination, tax research on, **2**:29–30
Creative works, definition of capital asset, **8**:5–6
Credit for child and dependent care expenses, **16**:54–56
calculation of, **16**:55–56
earned income ceiling, **16**:55
eligibility for, **16**:55
eligible employment-related expenses, **16**:55
Credit for employer-provided child care, **14**:11–12, **14**:15
Credit for small employer pension plan startup costs, **14**:11, **14**:14
Creditors' gifts, income from discharge of indebtedness, **4**:27
Credits. *See* Tax credits
Cumulative Bulletin (C.B.), **2**:10, **2**:11, **2**:16
Current E & P, **10**:4
pro rata basis allocation of, **10**:7
Current participation, tests based on, **6**:24–26
Current tax expense, **3**:9, **3**:10
Cyberspace
foreign tax credit and income sourced in, **14**:12
sourcing income in, **13**:9

D

Daily Tax Reports, **2**:10
Damages, **16**:33–34
compensatory, **16**:33
personal injury, **16**:34
punitive, **16**:34
taxation of, **16**:35
Data mining, **13**:30
De minimis exception of in house expenditures, **5**:9
De minimis fringe benefits, **17**:16, **17**:18
De minimis fringes, **17**:14
De minimis items, **17**:20
Death
disposition of a passive activity by, **6**:33–34
recapture potential of, **8**:36
Death taxes, **1**:9–10
federal estate tax, **1**:9
state death taxes, **1**:9
Deathbed gifts, **7**:15
Debt
advantages of, **9**:25–26
nonrecourse, **11**:22
qualified nonrecourse, **11**:29
recourse, **11**:22
that cannot be fully repaid, **9**:25
Debt in the capital structure, **9**:25–27
advantages of, **9**:25–26
reclassification of debt as equity (thin capitalization problem), **9**:26–27
Debt obligation, retirement of, **8**:8
Decedent
miscellaneous itemized deduction of Federal estate tax on income in respect of, **16**:52
property acquired from, **7**:14–16
Decisions
memorandum, **2**:16
regular, **2**:16
Deductible distributions, minimizing double taxation by making, **15**:11–12
Deductible taxes, planning strategies for timing the payment of, **16**:43
Deduction for contributions of property by individuals, determining, **16**:51
Deduction for qualified tuition and related expenses, **17**:30
Deductions, **4**:3–4
business, **5**:3–4
character of, **1**:24
determining the amount of, **17**:51–52
for capital expenditures, disallowance of, **5**:9–10
justification for denying, **5**:7
limitations on charitable contributions, **16**:50
planning strategies for shifting across time, **16**:25
planning strategies for the time value of, **5**:5
tax minimization strategies related to, **1**:22
time of, **16**:49
See also Itemized deductions
Deductions available only to corporations, **9**:28–31
dividends received deduction, **9**:28–29
organizational expenditures deduction, **9**:30–31
Deductions for AGI, **4**:3, **16**:5–6
business activities, **1**:15
business expenses of self-employed, **17**:3
business losses of individuals, **6**:11
health insurance premiums of self-employed, **17**:43
home office expense, **17**:35
HSA contributions, **16**:40
interest on qualified student loans, **16**:43
qualified tuition and related expenses, **17**:30
reimbursed employee expenses under an accountable plan, **17**:4, **17**:36
Section 1231 asset casualty losses, **8**:27
Section 1231 asset losses, **8**:27
self-employment tax, **17**:44
trade or business expenses, **16**:36
Deductions from AGI, **4**:3
casualty losses, **8**:27
hobby losses, **17**:51
itemized deductions, **1**:15, **16**:37
personal and dependency exemptions, **1**:15
personal-use losses of individuals, **6**:11
reimbursed employee expenses under a nonaccountable plan, **17**:36
transportation expenses, **17**:20
unreimbursed employee expenses, **17**:4, **17**:36
Deductions related to a proprietorship, **17**:43–45
health insurance premiums, **17**:43
ordinary and necessary business expenses, **17**:43
self-employment tax, **17**:43–45
Deemed to be long term, **7**:16
Deemed-paid credit, **13**:11
Defense of Marriage Act of 1996, **1**:33 (Pub. L. No. 104–199), **16**:11
Deferral and amortization method of research and experimental expenditures, **5**:18
Deferral and repatriation, planning strategies, **13**:9
Deferral of advance payments
for goods, **4**:12
for services, **4**:13
Deferred tax asset, **3**:10
Deferred tax benefit, **3**:10
Deferred tax expense, **3**:10
Deferred tax liability, **3**:10

Deficiency, payment of, **2**:13
Defined benefit plan, **17**:45
Defined contribution plan, **17**:45
Dependency exemptions, **16**:7, **16**:12–18
  citizenship or residency test, **16**:17
  comparison of categories for, **16**:17–18
  deductions from AGI, **1**:15
  joint return test, **16**:17
  other rules for, **16**:17
  phaseout of, **16**:18
  tests for, **16**:18
Dependent care expenses, credit for child and, **16**:56–56
  calculation of, **16**:55–56
  earned income ceiling, **16**:55
  eligibility for, **16**:55
  eligible employment-related expenses, **16**:55
Dependents
  basic standard deduction, **16**:10
  filing requirements for, **16**:20
  medical expenses for, **16**:39
  special limitations on the standard deduction for, **16**:10
Depletion, **5**:37–40
  intangible drilling and development costs (IDC), **5**:38
  of natural resources, **5**:22
Depletion methods, **5**:38–39
  planning strategies for switching, **5**:40
Depreciable real estate, **8**:32
  planning strategies for selling, **8**:36
Depreciable real property, **8**:33
Depreciated property, **7**:24
Depreciation
  and cost recovery allowances, capital recoveries, **7**:5
  basis for on gift property, **7**:13–14
  concepts relating to, **5**:23–24
  method and period, **11**:12
  of post-1986 personal property, AMT adjustments for, **14**:20–21
  of post-1986 real property, AMT adjustments for, **14**:19–20
  on fixed assets, **3**:6
Depreciation recapture
  and Section 179, planning strategies for, **8**:32
  comparison of Section 1245 and Section 1250, **8**:34
Depreciation rules, **5**:22
Determination letters, **2**:11
Dicta, **2**:24
Directly related to business, **17**:32
Disabled access credit, **14**:2, **14**:10–11, **14**:14
Disallowance possibilities, **5**:7–14
  disallowance of deductions for capital expenditures, **5**:9–10
  excessive executive compensation, **5**:9
  expenses and interest related to tax-exempt income, **5**:13–14
  investigation of a business, **5**:10–11
  lack of adequate substantiation, **5**:13
  political contributions and lobbying activities, **5**:8–9
  public policy limitations, **5**:7–8
  transactions between related parties, **5**:11–13
Disallowed loss transactions, **8**:14
Disallowed losses, **7**:16–17
  related taxpayers, **7**:16
  wash sales, **7**:16–17
Disaster area losses, **6**:9
Discharge of indebtedness, income from, **4**:26–29
  creditors' gifts, **4**:27
  insolvency and bankruptcy, **4**:27–28
  qualified real property indebtedness, **4**:28
  seller cancellation, **4**:28–29
  shareholder cancellation, **4**:29
  student loans, **4**:29
Disguised compensation, scholarships, **16**:33
Disguised sale, **11**:11
Disposition of a business or an ownership interest, **15**:21–25
  C corporation, **15**:24
  partnerships and limited liability entities, **15**:23
  S corporation, **15**:24–25
  sole proprietorships, **15**:22
Disposition of passive activities, **6**:33–34
Distance test, **17**:25
Distributions
  allocating E & P to, **10**:7–10
  corporate, **7**:6, **10**:2–3
  effect on recognition at time of, **15**:18–19
  from an S corporation, **12**:15
  liquidating and nonliquidating compared, **10**:25
  minimizing double taxation by not making, **15**:12–13
  of property in-kind, **12**:19
  partner's basis, gain and loss, **11**:24–25
District Court, **2**:11, **2**:12–13, **2**:13–15
  judicial citations of, **2**:17
  jurisdiction of, **2**:13
  See also Courts
Dividend payment react to tax law changes, **10**:19
Dividends, **4**:15–17, **10**:2
  constructive, **10**:15–20
  credit crunch triggers record cuts, **10**:13
  from foreign corporation, **4**:16
  percentage of, paid by size of corporate assets (2006), **10**:3
  property, **10**:12–15
  stock, **10**:20–21
  taxation of, **9**:5
  worldwide view of, **10**:17
Dividends received deduction (DRD), **1**:22, **9**:28–29
Divorced or separated parents, multiple support agreement and children of, **16**:16
Domestic production activities deduction (DPAD), **5**:20–22, **11**:18–19
  calculation of, **5**:20–21
Domestic production gross receipts (DPGR), **5**:21, **11**:18
Domestic subsidiaries, **3**:4, **9**:3
Domestic travel, **17**:23
Double tax benefit, restrictions on, education tax credits, **16**:57–58
Double tax effect, corporate income, **9**:3
Double taxation, **1**:24–25, **12**:28
  C corporations, **11**:3
  minimizing, **15**:11–15
  single vs., **15**:7–10
Dual basis rule, **7**:12

E

E & P. *See* Earnings and profits
Earned income ceiling, credit for child and dependent care expenses, **16**:55
Earned income credit, **16**:58–59
  advance payment, **16**:58–59
  amount of, **16**:58
  eligibility requirements, **16**:58
Earnings and profits (E & P), **10**:3–11
  accounting method adjustments, **10**:5
  additions to taxable income, **10**:4
  allocating to distributions, **10**:7–10
  computation of, **10**:4–7
  effect of corporate distributions on, **10**:14–15
  impact of various transactions on, **14**:26
  subtractions from taxable income, **10**:4
  summary of adjustments, **10**:7
  timing adjustments, **10**:5
Earnings of foreign subsidiaries, **3**:16–18
Easements, capital recoveries, **7**:6
EBITDA, earnings before interest taxes depreciation, and amortization, **3**:27
Economic and societal needs, senior citizens, **17**:7
Economic considerations
  encouragement of certain activities, **1**:28
  encouragement of certain industries, **1**:28–29
  encouragement of small business, **1**:29
  tax law, **1**:35
Economic effect of partnership allocations, **11**:19–20
Economic effect test, **11**:20
Economic income, **4**:4
  and accounting concepts of income, **4**:4–5
Economic performance test, **5**:6
Economic Stimulus Act of 2008, **2**:3, **5**:26
Economics
  business cycle and, **5**:32
  finance, **4**:9, **5**:36
  investments, **16**:29
  nontaxable exchanges, **7**:27
  role of small businesses, **15**:14
Education expenses, **17**:28–30
  classification of specific items, **17**:29–30
  maintaining or improving existing skills, **17**:29
  planning strategies for, **17**:29
  requirements imposed by law or by the employer for retention of employment, **17**:28–29
Education interest, deductibility of, **16**:48
Education tax credits, **16**:56–58
  eligible individuals, **16**:56–57
  income limitations and refundability of, **16**:57
  maximum credit, **16**:56
  restrictions on double tax benefit, **16**:57–58
Educational savings bonds, **16**:35–36
Effective tax rate, **1**:26

for selected fortune 100 companies, **3**:22
planning strategies for reducing with ASC 740-30 (APB 23), **3**:19
Effectively connected income, **13**:19
E-file, **16**:20
Eighty percent stock ownership, **9**:11
Election, loss of, **12**:8–10
loss of small business corporation status, **12**:9
passive investment income limitation, **12**:10
reelection after termination, **12**:10
voluntary revocation, **12**:9
Election, S corporation status, **12**:7–8
Election to expense assets under Section 179, **5**:31–32
annual limitations, **5**:31–32
effect on basis, **5**:32
Election to report certain unearned income on parent's return, **16**:27–28
Form 8814, **16**:27
Electronic return originator (ERO), **16**:20
Electronic tax services, **2**:27–28
Eligible access expenditures, **14**:11
Eligible small business, **14**:11
Emergency Economic Stabilization Act of 2008, **5**:10
Eminent domain, **7**:29
Employee achievement awards, **16**:31
Employee expenses, **17**:19–42
accountable plans, **17**:37
certain expenses for teachers, **17**:35–36
classification of, **17**:36–38
contributions to individual retirement accounts, **17**:38–42
education expenses, **17**:28–30
entertainment expenses, **17**:31–33
Form 2106, Employee Business Expenses, **17**:3
itemized deductions, **16**:36
limited deduction approach, **17**:30–31
miscellaneous employee expenses, **17**:36
moving expenses, **17**:25–27
nonaccountable plans, **17**:37
office in the home, **17**:33–35
other, **17**:33–36
transportation expenses, **17**:20–21
travel expenses, **17**:22–24
unreimbursed expenses, **17**:38
Employee fringe benefits, other, **17**:11–12
Employee tuition assistance offers benefits to employers too, **17**:12
Employee vs. self-employed, **17**:3–5
factors considered in classification, **17**:4–5
Employees
advantages of qualified fringe benefits, **17**:5–6
cafeteria plans, **17**:12–13
employer-sponsored accident and health plans, **17**:6
exclusions available to, **17**:5–19
flexible spending plans, **17**:13
foreign earned income, **17**:18–19
general classes of excluded benefits, **17**:13–18
group term life insurance, **17**:10–11
highly compensated, **17**:17
long-term care benefits, **17**:7–8
meals and lodging furnished for the convenience of the employer, **17**:8–10
medical reimbursement plans, **17**:6–7
other specific employee fringe benefits, **17**:11–12
partners as, **11**:32
qualified tuition reduction plans, **17**:11
services of, **4**:14
taxable fringe benefits, **17**:18
Employer, meals and lodging furnished for the convenience of, **17**:8–10
furnished by the employer, **17**:8
on the employer's business premises, **17**:8–9
required as condition of employment, **17**:9–10
Employer-sponsored accident and health plans, **17**:6
Employment taxes, **1**:3, **1**:8–9
FICA taxes, **1**:8
Form 941, **1**:8
self-employment taxes, **1**:8
unemployment taxes, **1**:8–9
Employment-related expenses, credit for child and dependent care expenses, **16**:55
Energy credits, **14**:10, **14**:14
Energy research credit, **14**:10
Engaged in a trade or business test, **13**:5
Entertainment expenses, **17**:31–33
business gifts, **17**:33
classification of, **17**:32
fifty percent cutback, **17**:31–32
planning strategies for, **17**:32
restrictions upon deductibility of business meals, **17**:33
restrictions upon deductibility of club dues, **17**:33
Entities
dealings between individuals and, **1**:19
different reporting, **3**:3–5
effect on recognition at time of contribution to, **15**:15–16
percentage of U.S. reporting, tax year 2007, **11**:6
special purpose, **3**:3
tax year 2005 reported profitability of, **11**:28
Entity approach, corporations, **15**:16
Entity classification, **9**:8
Entity concept, **15**:15
double taxation for C corporations, **15**:17–18
Entity treatment, conduit vs., **15**:15–21
effect of at-risk rules, **15**:19–20
effect of special allocations, **15**:20–21
effect on basis of ownership interest, **15**:16–17
effect on passive activity losses, **15**:19
effect on recognition at time of contribution to the entity, **15**:15–16
effect on recognition at time of distribution, **15**:18–19
effect on results of operations, **15**:17–18
Entity-level taxes, **12**:25–29
passive investment income penalty tax, **12**:28–29
tax on pre-election built-in gain, **12**:25–28
Equity considerations
alleviating the effect of multiple taxation, **1**:30
coping with inflation, **1**:31
mitigating effect of the annual accounting period concept, **1**:31
tax law, **1**:35
wherewithal to pay concept, **1**:30–31
Equity method, **3**:3
Equity or fairness
employee or independent contractor, **17**:3
marriage penalty tax, **16**:22
Equity, reclassification of debt as (thin capitalization problem), **9**:26–27
Estate tax, **1**:9
Estimated tax, **17**:49
Estimated tax payments, **9**:34–35, **17**:48–50
for individuals, **17**:49
Individuals, Form 1040-ES, **16**:25
penalty on underpayments, **17**:49–50
Excess cost recovery, **5**:35
Excess net passive income (ENPI), **12**:28
Excessive executive compensation, **5**:9
Exchange, **11**:10–11
Excise taxes, **1**:4
federal, **1**:5
local, **1**:6
state, **1**:5–6
Exclusions, **16**:4
exceptions to, **4**:24–26
from the income tax base, **4**:3
Executive compensation
cost accounting and, **13**:32
deductibility of, **5**:10
Exemptions
dependency, **16**:7, **16**:12–18
personal, **16**:7, **16**:10–11
phaseout of dependency and personal, **16**:18
Expatriates and the moving expense deduction, **17**:26
Expenditures, research and experimental, **5**:17–18
Expense, capitalization vs., **5**:10
Expense method of research and experimental expenditures, **5**:17
Expense recognition, timing of, **5**:5–6
accrual method requirements, **5**:6
cash method requirements, **5**:5
Expense rules
domestic production activities deduction, **5**:20–22
interest expense, **5**:18–19
other, **5**:18–22
taxes, **5**:19–20
Expenses
and income, accrued, **3**:6
and interest related to tax-exempt income, **5**:13–14
classification of employee, **17**:36–38
compensation-related, **3**:6
nondeductible, **3**:7
related to an illegal business, **5**:9
See also Employee expenses
Expensing asset costs for home office, **5**:26
Experimental expenditures
deferral and amortization method of, **5**:18
expense method of, **5**:17
research and, **5**:17–18
Explicit taxes, **1**:27

F

Facts and circumstances, tests based on, **6**:26–27
Failure to disclose penalty, **2**:7
Fair market value, **7**:4
  charitable contributions, **5**:15
Farm property, **5**:29–30
Farming assets, cost recovery periods for, **5**:30
FAS 5, Accounting for Contingencies, **3**:17
FASB, **3**:4, **3**:5, **3**:11
  Accounting Standards Codification (ASC), **3**:4
  Compensation—Stock Compensation ASC Topic 718-10, **3**:5
FDAP (fixed and determinable annual or periodic payments), **11**:17, **13**:20
Federal customs duties, **1**:13–14
Federal estate tax, **1**:9
  on income in respect of a decedent, miscellaneous itemized deductions, **16**:52
Federal excise taxes, **1**:5
  Form 720, **1**:5
Federal gift tax, **1**:10–11
Federal income tax
  basic formula for, **1**:15
  formula for individuals, **1**:15
  structure of, **1**:14–15
  who pays corporate, **15**:12
Federal Insurance Contribution Act. *See* FICA
Federal judicial system, **2**:12
  trial courts, **2**:14
Federal Register, **2**:9
Federal Second Series (F.2d), **2**:17
Federal Supplement Second Series (F.Supp.2d), **2**:17
Federal Supplement Series (F.Supp), **2**:17
Federal tax collections, **1**:12
Federal tax consequences of business entities, **11**:3–4
Federal Tax Coordinator 2d, **2**:21
Federal tax law, understanding, **1**:27–35
Federal Third Series (F.3d), **2**:17
Federal Unemployment Tax Act. *See* FUTA
Fees, **16**:41
FICA, **1**:8
  tax, **1**:8
Fiduciaries, Form 1041, **11**:16
Fifty percent ceiling on charitable contributions, **16**:50
Fifty percent cutback, **17**:31–32
Filing considerations, **16**:18–23
  filing requirements, **16**:19–21
  filing status, **16**:21–23
Filing requirements, **16**:19–21
  e-file approach, **16**:20
  for corporations, **9**:34
  for dependents, **16**:20
  mode of payment, **16**:21
  selecting the proper form, **16**:20
  when and where to file, **16**:20
Filing status, **16**:21–23
  rates for heads of household, **16**:22–23
  rates for married individuals, **16**:21–22
  rates for single taxpayers, **16**:21
FIN 48, *Accounting for Uncertainty in Income Taxes*, **3**:4, **3**:17
Final Regulations, **2**:9
Finance
  business entities, **5**:23
  cash-flow benefit of particular tax attributes, **14**:5
  dividend policies, **10**:9
  double tax on corporate income, **10**:14
  economics and, **4**:9, **5**:36
  investments, **9**:6, **16**:29
  limited partnerships, **11**:4
  reduce cost of taxation, **6**:16
  stock buybacks, **10**:22
Financial accounting
  book a reserve or cushion, **3**:17
  business entity, **15**:8
  capital account, **11**:8
  definition of income, **4**:5
  maximizing net income, **8**:31
  measures of corporate income, **9**:37
  property transactions, **7**:5
Financial Accounting Standards Board. *See* FASB
Financial net income, reconciliation of taxable income and, **9**:35–37
Financial statement analysis, **3**:27
Financial statements
  earnings of foreign subsidiaries, **3**:16–18
  financial analysts use of, **3**:27
  GAAP principles, **3**:9–13
  income taxes in, **3**:9–25
  tax disclosure in, **3**:19–25
  valuation allowance, **3**:13–16
Fines, **5**:7
First-in, first-out (FIFO) basis, **7**:9
Fiscal year, **4**:7
Fixed assets
  classification of, **8**:25
  depreciation on, **3**:6
Fixed, determinable, annual or periodic income. *See* FDAP
Fixture, **1**:11
Flat tax, **1**:3
Flexible spending plans, **17**:13
Flow-through entities, **1**:19, **1**:25, **11**:3
Flow-through of separate items of income and loss to S corporation shareholders, **12**:11
Food, Conversation, and Energy Act of 2008, **2**:3
Foreign Corrupt Practices Act of 1977, more prosecutions under, **5**:7
Foreign earned income, **17**:18–19
  exclusion, **17**:19
Foreign partners, various withholding procedures applicable to, **11**:17
Foreign person's income, U.S. tax treatment of, **13**:20
Foreign property, exchange for, yields recognized recapture gain, **8**:37
Foreign subsidiary, **9**:3
  earnings of, **3**:16–18
Foreign tax credit (FTC), **13**:7, **13**:11–14, **14**:2, **14**:12–13, **14**:15
  AMT and, **14**:29
  corporate use of, **13**:12
  planning strategies for utilizing, **13**:13
  sourcing income in cyberspace, **14**:12
Foreign taxes, deductibility of, **16**:43
Foreign travel, **17**:24
Form 720, Federal excise tax return, **1**:5
Form 940, Employer's Annual Federal Employment Tax Return, **1**:9
Form 941, Employer's Quarterly Federal Tax Return, FICA taxes, **1**:8
Form 1040, U.S. Individual Income Tax Return, **1**:8, **1**:18, **11**:16, **16**:20, **17**:31
  Schedule A, Itemized Deductions, **16**:47, **17**:3
  Schedule C, Profit or Loss from Business, **17**:3
Form 1040A, **16**:20, **17**:31
Form 1040-ES, Estimated Tax for Individuals, **16**:25
Form 1040EZ, **16**:20
Form 1041, fiduciaries, **11**:16
Form 1065, partnerships, **1**:18, **15**:4
Form 1120, C corporation, **1**:18, **9**:3, **11**:16, **15**:4
Form 1120S, S corporations, **1**:18, **11**:16, **15**:4
Form 2106, Employee Business Expenses, **17**:3
Form 2553, S election, **12**:7, **12**:8
Form 4626, Alternative Minimum Tax—Corporations, **14**:15
Form 4684, Casualties and Thefts, **8**:38
Form 4797, Sales of Business Property, **8**:38
Form 4868, Application for Automatic Extension of Time to File U.S. Individual Income Tax Return, **16**:20
Form 8283, Noncash Charitable Contributions, **16**:49
Form 8814, Parents' Election to Report Child's Interest and Dividends, **16**:27
Form 8824, like-kind exchange, **7**:22
Form 8829, Expense for Business Use of Your Home, **17**:34
Form 8895, One Time Dividends Received Deduction for Certain Cash Dividends from Controlled Foreign Corporations, **13**:16
Form 8903, **5**:22
Form 8917, Tuition and Fees Deduction, **17**:31
Form of receipt of gross income, **4**:6–7
Form W-2, Wage and Tax Statement, **16**:25
Forms of doing business. *See* Business entities
401k plan, **17**:47
Franchise tax, **1**:4
Franchises, **8**:11–12
  contingent payments, **8**:12
  noncontingent payments, **8**:12
  Section 197 intangible, **5**:37
  significant power, right, or continuing interest, **8**:11
Fringe benefits
  advantages of qualified, **17**:5–6
  general classes, **17**:20
  other specific employee, **17**:11–12
  taxable, **17**:18
Fruit and tree metaphor, **4**:13–14
Full recapture, **8**:30
Functional use test, **7**:29
FUTA, **1**:8
  tax, **1**:8

G

GAAP. *See* generally accepted accounting principles
Gain
  adjusted, **14**:21–23
  built-in, **11**:20
  casualty, **6**:11
  determination of, **7**:3–8
  from capital assets, preferential treatment of, **8**:3
  from property transactions, **4**:29–31
  long-term, **8**:16–19
  nonrecognition of, **7**:7, **9**:8–9
  on property dividends, recognition of, **10**:13–14
  or loss on contributions to the partnership, **11**:9–10
  precontribution, **11**:20
  short-term, **8**:16
  with losses, planning strategies for matching, **8**:22
  See also Capital gains; Realized gain; Recognized gain
Gain basis for converted property, **7**:17
Gambling losses, miscellaneous itemized deductions, **16**:52
General business asset class, **7**:22
General business credit, **14**:3–5, **14**:14
  principal components of, **14**:4
  treatment of unused, **14**:4–5
General Counsel Memoranda (GCMs), **2**:11
General partner, **6**:28
  at-risk limitation, **6**:17
  unlimited liability, **9**:7
General partnership, **11**:5
  LLC advantages over, **15**:5
General sales tax, **1**:6–7
General welfare exception, **4**:14
Generally accepted accounting principles (GAAP), **3**:3, **3**:9–13, **9**:38
Gift basis, **7**:11–14
  adjustment for gift tax, **7**:12–13
  basis for depreciation, **7**:13–14
  holding period, **7**:13
  rules if no gift tax is paid, **7**:11–12
Gift loans, imputed interest rules, **4**:20
Gift splitting, **1**:10
Gift taxes, **1**:3, **1**:10–11
  adjustment for, **7**:12–13
  federal, **1**:10–11
  state, **1**:11
Gifts, **16**:31
  and inheritances, **16**:31–32
  business, **17**:33
  criteria for, **16**:47
  deathbed, **7**:15
  disposition of a passive activity by, **6**:34
  made before 1977, **7**:13
  of appreciated securities, planning strategies for, **8**:17
  planning strategies for, **7**:12
  recapture potential of, **8**:35–36
Global approach to taxation, filing a joint return, **16**:23
Global business structures, **3**:3
Global system approach to taxation, **16**:6
Going-concern value, Section 197 intangible, **5**:36–37
Golsen case, **2**:15
Goods
  deferral of advance payments for, **4**:12
  taxes on the production and sale of, **1**:5–7
Goodwill, **7**:10, **17**:32
  Section 197 intangible, **5**:36
Government Accountability Office (GAO), **6**:30, **15**:9, **17**:44
Government's interest in our work, **16**:4
Government-provided economic incentives, expansion projects, **9**:24
Grantee, exercise of options by, **8**:10
Green Book, **13**:19
Gross estate, **1**:9
Gross income, **4**:3, **4**:4–7, **16**:4–5
  adjusted, **16**:6–7
  economic and accounting concepts of income, **4**:4–5, **4**:6
  form of receipt, **4**:6–7
  inclusion amount for leased automobiles in, **5**:35
  partial list of exclusions from, **16**:5
  planning strategies for reducing, **4**:17
  Section 61(a) definition of, **1**:20
  specific items of, **4**:18–31
  See also Foreign earned income; Income; Income sources
Gross income test, for qualifying relative, **16**:14
Group term life insurance, **17**:10–11
Guaranteed payments, **11**:30–31

H

H.R. 10 (Keogh) plans. *See* Keogh plans
Half-year convention, **5**:25
Head-of-household, **16**:22–23
  rates for, **16**:22–23
Health insurance premiums, **17**:43
Health Savings Accounts (HSA), **16**:39–41, **17**:7
  deductible amount, **16**:40–41
  high-deductible plans, **16**:40
  tax treatment of contributions and distributions, **16**:40
Highly compensated employees, **17**:17
Hobby losses, **17**:50–52
  determining the amount of the deduction, **17**:51–52
  general rules, **17**:50
  presumptive rule of Section 183, **17**:50–51
Holder, **8**:10
  defined, **8**:11
Holding, **2**:24
Holding companies, planning strategies, **13**:34
Holding period, **7**:13, **8**:13–15
  disallowed loss transactions, **8**:14
  for shareholder and transferee corporation, **9**:22–23
  inherited property, **8**:15
  nontaxable exchanges, **8**:13–14
  nontaxable transactions involving carryover of another taxpayer's basis, **8**:14
  of a partner's interest, **11**:12
  of new stock or securities, **7**:17
  of property acquired from a decedent, **7**:16
  of property received, **7**:25–26
  short sales, **8**:15
  special holding period rules, **8**:13–15
Home equity loans, **16**:45
Home office, expensing asset costs for, **5**:26
HOPE scholarship credit. *See* American Opportunity Credit
House of Representatives, **2**:3–5
House Ways and Means Committee, **2**:3–5
Housing Assistance Tax Act of 2008, **2**:3
Hybrid method, **4**:7, **4**:10

I

IAS 12, **3**:11
Identification problems, cost basis, **7**:9
Impairment-related work expenses, miscellaneous itemized deductions, **16**:52
Implicit taxes, **1**:27
Imputed interest on below-market loans, **4**:19–22
  exceptions and limitations, **4**:20–22
Inbound issues, **13**:19–21
Inbound taxation, **13**:4
Income, **4**:4
  accounting, **4**:5, **4**:6
  active, **6**:16, **6**:18
  assignment of, **4**:14
  broadly conceived, **4**:3, **16**:3–4
  bunching of, **8**:3
  character of, **1**:24
  computation of taxable, **12**:11–12
  division of, multijurisdictional taxation, **13**:29–30
  economic, **4**:4
  expenses related to production or collection of, **16**:36
  how much and what type, **4**:15
  nontaxable, **3**:7
  passive, **6**:16, **6**:18
  planning strategies for where it should go, **13**:28
  portfolio, **6**:16, **6**:18
  prepaid, **4**:12
  Section 61 broad definition of, **4**:4
  Subpart F, **13**:14
  tax concepts of, **4**:6
  tax minimization strategies related to, **1**:20–22
  U.S. tax treatment of a foreign person's, **13**:20
  windfall, **4**:5
  See also Gross income; Income sources
Income and expenses, accrued, **3**:6
Income and loss
  allocation of, **12**:12–14
  to S corporation shareholders, flow-through of separate items of, **12**:11
Income from discharge of indebtedness, **4**:26–29
  creditors' gifts, **4**:27
  gross income exclusion, **4**:18
  insolvency and bankruptcy, **4**:27–28
  qualified real property indebtedness, **4**:28
  seller cancellation, **4**:28–29

Income from discharge of indebtedness *(contd.)*
shareholder cancellation, **4**:29
student loans, **4**:29
Income from property, **4**:14–17
dividends, **4**:15–17
interest, **4**:15
Income in respect of a decedent, miscellaneous itemized deduction of Federal estate tax on, **16**:52
Income of a proprietorship, **17**:43
Income of certain children, planning strategies for, **16**:28
Income provisions applicable to individuals, overview of, **16**:28
Income received by an agent, **4**:17
Income shifting, **1**:23, **13**:28, **16**:25
Income sources, **4**:13–17
crossing state lines, **13**:24–28
from sales of inventory, planning strategies, **13**:10–11
in cyberspace, **13**:9, **14**:12
income from property, **4**:14–17
income received by an agent, **4**:17
multinational transactions, **13**:8–11
personal services, **4**:13–14
Income splitting option, **16**:22
Income Tax Act of 1913, **16**:31
Income tax liability, determining the corporate, **9**:31–32
Income tax planning, general framework for, **1**:20, **1**:21
Income tax provision, **3**:9
Income tax rates, corporate, **9**:31–32
Income tax returns
as a use tax reminder, **1**:17
number of filed by different types of taxpayers, **15**:15
Income tax treaties, **13**:4, **13**:5
Income taxation in the U.S., state and local income, crossing state lines, **13**:20–29
Income taxes, **1**:14–17
accounting for in international standards, **3**:11
local, **1**:17, **16**:42–43
state, **1**:16, **16**:42–43
structure of federal, **1**:14–15
who pays corporate federal, **15**:12
Income taxes in the financial statements, **3**:9–25
earnings of foreign subsidiaries, **3**:16–18
GAAP principles, **3**:9–13
tax disclosures in the financial statements, **3**:19–25
valuation allowance, **3**:13–16
Incremental research activities credit, **14**:8–9
Independent contractor, **17**:2, **17**:3
Indexation, **1**:31
Individual retirement accounts (IRAs), **17**:38
contributions to, **17**:38–42
Coverdell Education Savings Account (CESA), **17**:41–42
deduction of an active participant, phaseout of, **17**:39
losses from Ponzi schemes, **17**:41
planning strategies of important dates related to, **17**:47
Roth IRAs, **17**:40–41
spousal, **17**:38
traditional IRAs, **17**:38–39
vacillating popularity of, **17**:40
Individual retirement plans for self-employed individuals, **17**:45–48
Individual tax credits. *See* Tax credits for individuals
Individual tax formula, **16**:3–8
Individuals
casualty and theft losses, **6**:11–12
dealings between entities and, **1**:19
determining the deduction for contributions of property by, **16**:51
Form 1040, **11**:16
overview of income provisions applicable to, **16**:28
specific exclusions applicable to, **16**:31–36
specific inclusions applicable to, **16**:28–31
Individuals as proprietors, **17**:42–50
accounting periods and methods, **17**:48
deductions related to a proprietorship, **17**:43–45
estimated tax payments, **17**:48–50
income of a proprietorship, **17**:43
proprietorship as a business entity, **17**:42–43
retirement plans for self-employed individuals, **17**:45–48
Ineligible corporations, S status, **12**:5
Inflation, **1**:31
Inheritance tax, **1**:9
Inheritances, **16**:31–32
Inherited property, **7**:14–16, **8**:15
holding period for, **8**:15
Initial test, for corporate AMT exemption, **14**:13
Inside basis, **11**:13
Insolvency and bankruptcy, **4**:27–28
Installment method, **1**:31, **4**:7
Insurance policies, certain exchanges of, **7**:31
Intangible assets, **3**:6, **11**:12
Intangible drilling and development costs (IDC), **5**:38
Intangible property, **1**:12
Intangible real property, **8**:33
Inter vivos gifts, **16**:31
Interest, **4**:15, **16**:43–47
basis in the partnership, **11**:9
capital, **11**:8
deductibility of personal, education, investment, and mortgage, **16**:48
investment, **16**:44
prepaid, **16**:47
prepayment penalty, **16**:46
profits (loss), **11**:8
qualified residence, **16**:45–46
tax-exempt securities, **16**:46
U.S. Supreme Court rules on state taxation of other states', **4**:22
Interest earned, **4**:11
Interest expense, **5**:18–19
classification of, **16**:47
Schedule A of Form 1040, **16**:47
Interest on certain state and local government obligations, **4**:22–24
Interest on qualified student loans, **16**:43–44
Interest on state and local bonds (Section 103), gross income exclusion, **4**:18
Interest paid
for services, **16**:46
to related parties, **16**:46
Interest related to tax-exempt income, **5**:13–14
judicial interpretations, **5**:14
Interjurisdictional agreements, multijurisdictional taxation, **13**:34–35
Internal Revenue Bulletin (I.R.B.), **2**:9–10, **2**:11, **2**:16
Internal Revenue Code, **1**:34, **13**:4
arrangement of, **2**:5–6
citing of, **2**:6–7
interpretation pitfalls, **2**:22
interpreting, **2**:22
of 1939, **2**:3
of 1954, **2**:3
of 1986, **2**:3
origin of, **2**:3
Internal Revenue Service
accounting method prescribed by, **4**:7
administrative feasibility of, **1**:33–34
an electronic, **2**:30
influence of, **1**:33–34, **1**:35
Letter Rulings Reports, **2**:10
Office of Research, Analysis, and Statistics, **7**:22
International Accounting Standards Board (IASB), **3**:5, **3**:11, **3**:28
International Financial Reporting Standards (IFRS), **3**:28
impact of on Schedule M-3, **9**:38
International law, international transactions, **13**:3
International tax rates, **13**:7
International transactions, U.S. taxation of, **13**:4
Internet, **2**:28–29
sales, sales/use tax on, **13**:31
Interpretive Regulations, **2**:23
Inventory
definition of capital asset, **8**:4–5
tax issues related to contributed property, **11**:12–13
Investment earnings, **4**:25
Investment interest, **16**:44
deductibility of, **16**:48
Investment property
complete destruction of, **6**:10
partial destruction of, **6**:10
Investments, **8**:3, **10**:12
Involuntary conversions, **7**:28, **8**:26
defined, **7**:28
planning strategies for recognizing gain, **7**:28
recapture potential of, **8**:37
replacement property, **7**:29–30
Section 1033, **7**:27–31
time limitation on replacement, **7**:30–31
IRA. *See* Individual retirement account
IRS. See Internal Revenue Service
Itemized deductions, **16**:7, **16**:36–53
charitable contributions, **16**:47–52
deductions from AGI, **1**:15
interest, **16**:43–47
medical expenses, **16**:37–41
miscellaneous itemized deductions subject to two percent floor, **16**:52

other miscellaneous, **16**:52
overall limitation of certain, **16**:53
partial list of, **16**:37
planning strategies for effective utilization of, **16**:53
Schedule A, Form 1040, **17**:3
taxes, **16**:41–43

J

Janitor's insurance, **4**:25
Jobs credit, **14**:10
Joint return
planning strategies problems with, **16**:17
test for dependency exemptions, **16**:17
Joint venture, **11**:2
Judicial citations, **2**:15–18
Judicial concepts relating to tax, **1**:34–35
Judicial influence on statutory provisions, **1**:35
Judicial interpretations of expenses and interest related to tax-exempt income, **5**:14
Judicial opinions, understanding, **2**:24
Judicial process in general, **2**:11–12
Judicial sources of the tax law, **2**:11–18
appellate courts, **2**:13–15
assessing the significance of, **2**:23–24
judicial citations, **2**:15–18
judicial process in general, **2**:11–12
trial courts, **2**:12–13
Jury trial, **2**:13

K

Keogh plans, **17**:45–46
planning strategies of important dates related to, **17**:47
Kickbacks, **5**:7
Kiddie tax, **8**:17, **16**:26–28

L

Law, sources of
in crossing state lines, **13**:21–23
in U.S. taxation of multinational transactions, **13**:4–5
Lease cancellation payments, **8**:12–13
Leased automobiles, inclusion amount in gross income, **5**:35
Leased property, improvements on, **4**:24
Leasehold improvement property, **5**:30–31
fair market value of when lease is terminated (Section 109), gross income exclusion, **4**:18
Legal expenses incurred in defense of civil or criminal penalties, **5**:8–9
Legislation
influencing local, **5**:9
monitoring, **5**:9
Legislative process, **2**:3–5
for tax bills, **2**:4
Legislative Regulations, **2**:23
Lessee, **8**:12
treatment, **8**:13
Lessor, **8**:12
treatment, **8**:13
Letter Ruling Review, **2**:10
Letter rulings, **2**:10
Liabilities in excess of basis, **9**:16–17
Liabilities, partnership, **11**:22–23
Life insurance proceeds, **4**:24–26
exceptions to exclusion treatment, **4**:24–26
planning strategies for, **4**:26
received by reason of death of the insured (Section 101), gross income exclusion, **4**:18
Lifetime learning credit, **16**:56, **16**:57, **17**:31, **17**:42
LIFO recapture tax, **12**:28
Like-kind exchanges, **7**:20–26
basis and holding period of property received, **7**:25–26
boot, **7**:24–25
exchange requirement, **7**:23–24
Form 8824, **7**:22
like-kind property, **7**:21–23
planning strategies for, **7**:21
popularity of, **7**:22
recapture potential of, **8**:37
Section 1031, **7**:20–26
Like-kind property, **7**:21–23
basis of, **7**:25
Limited deduction approach, **17**:30–31
Limited liability, **15**:6
Limited liability companies (LLC), **1**:19, **6**:28, **9**:7–8, **11**:5, **11**:6, **11**:33–35, **15**:4–5
advantages of, **11**:34–35
disadvantages of, **11**:35, **15**:5
taxation of, **11**:33
Limited liability entities, **11**:33–35, **15**:3–4
conduit concept, **15**:18
disposition of, **15**:23, **15**:25
tax attributes of, **15**:27–30
See also Limited liability company; Limited liability partnerships
Limited liability limited partnership (LLLP or "triple-LP"), **11**:5
Limited liability partnership (LLP), **1**:19, **6**:28, **11**:5, **11**:35
Limited partners, **6**:28
Limited partnerships, **9**:7, **11**:5
LLC advantages over, **15**:4
with a corporate general partner, **15**:7
Liquidation process, **10**:24–25
Listed property, **5**:32
business and personal use of automobiles and other, **5**:32–36
change from predominantly business use, **5**:35
not used predominantly in business, **5**:32, **5**:35
substantiation requirements, **5**:36
used predominantly in business, **5**:32, **5**:33
Loans
below-market, **4**:19–22
between related parties, **6**:5–6
to a corporation by shareholders, **10**:18
to executives prohibited, **4**:19
to shareholders, **10**:16–17
Lobbying expenditures, **5**:8–9
exceptions, **5**:9
Local excise taxes, **1**:6
Local income taxes, **1**:17
Local legislation, influencing of, **5**:9
Lodging and meals furnished for the convenience of the employer, **17**:8–10
Lodging, medical expenses for, **16**:39
Long-term care benefits, **17**:7–8
Long-term family assistance recipient, **14**:8
Long-term gains, **8**:16–19, **8**:20
Long-term nonpersonal-use capital assets, **8**:26
Loss basis for converted property, **7**:17
Loss considerations, planning strategies for, **12**:23
Loss limitations, **11**:26–29
at-risk limitation, **11**:28–29
basis limitation, **11**:26–28
passive activity rules, **11**:29
Loss of the election, **12**:8–10
loss of small business corporation status, **12**:9
passive investment income limitation, **12**:10
reelection after termination, **12**:10
voluntary revocation, **12**:9
Loss on contributions to the partnership, **11**:9–10
Loss property
basis adjustment for, **9**:20–22
recognition of dividends, **10**:13–14
Loss to S corporation shareholders, flow-through of separate items of income and, **12**:11
Loss transactions, disallowed, **8**:14
Losses
adjusted, **14**:21–23
allocation of, **12**:12–14
at-risk rules, **12**:24
built-in, **11**:20
business property, **6**:7
capital, **8**:3, **8**:16, **8**:19–22
casualty and theft, **6**:7–12
determination of, **7**:3–8
hobby, **17**:50–52
net operating, **3**:6, **12**:22–23
nonrecognition of, **7**:7, **9**:8–9
on subprime mortgages, **8**:7
ordinary, **6**:5, **6**:6
passive losses and credits, **12**:24
planning strategies for matching gains with, **8**:22
precontribution, **11**:20
realized, **7**:3–6
recognized, **7**:6–7
recovery of capital doctrine, **7**:7–8
S corporation, **12**:25
short-term capital, **6**:5
tax issues related to contributed property, **11**:12–13
treatment of, **12**:22–24
worthless securities, **6**:6–7
Losses from property transactions, **4**:29–31
capital gains and losses, **4**:30–31
in transactions between related parties, **5**:11–12
Losses last rule, **11**:27, **12**:20
Losses of individuals, casualty and theft, **6**:11–12
Low-income housing credit, **14**:14

M

MACRS. *See* Modified accelerated cost recovery system
Making Work Pay credit, **16**:59
Manufactured, produced, grown, or extracted (MPGE), **5**:21
Marginal tax rate, **1**:26, **16**:24
Marital deduction, **1**:9
Marital status for exemption purposes, **16**:11
Marriage penalty, **16**:22
  tax, equity or fairness, **16**:22
Married individuals, rates for, **16**:21–22
Material participation, **6**:24–28, **6**:32
  corporations, **6**:28
  limited partners, **6**:28
  participation defined, **6**:27–28
  tests based on current participation, **6**:24–26
  tests based on facts and circumstances, **6**:26–27
  tests based on prior participation, **6**:26
Meals and lodging furnished for the convenience of the employer, **17**:8–10
  furnished by the employer, **17**:8
  on the employer's business premises, **17**:8–9
  required as condition of employment, **17**:9–10
Medical care, **16**:37
Medical expense deduction, planning strategies for the multiple support agreement and, **16**:16
Medical expenses, **16**:37–41
  capital expenditures, **16**:38–39
  cosmetic surgery, **16**:38
  defined, **16**:37
  examples of deductible and nondeductible, **16**:38
  for spouse and dependents, **16**:39
  health savings accounts, **16**:39–41
  nursing home care, **16**:38
  transportation and lodging, **16**:39
Medical reimbursement plans, **17**:6–7
Medical savings accounts (MSAs), **17**:7
Member-of-the-household test, multiple support agreement and, **16**:15
Memorandum decisions, **2**:16
Mid-month convention, **5**:28
Mid-quarter convention, **5**:26–28
Military Family Tax Relief Act of 2003, **17**:23
Millionaires provision, **5**:9
Minimum tax credit, **14**:28–29
Miscellaneous employee expenses, **17**:36
Miscellaneous itemized deductions, **16**:52
  subject to two percent floor, **16**:52
Mode of payment, **16**:21
Modified accelerated cost recovery system (MACRS), **5**:22, **5**:24
  computational rules: statutory percentage and straight-line methods, **5**:29
  cost recovery, **10**:5
  cost recovery tables, **5**:41–42
  depreciation on fixed assets, **3**:6
  property, **14**:19–21
  recovery periods, **14**:19–21
Modified adjusted gross income (MAGI), **5**:20, **16**:36
Monitoring legislation, **5**:9
Mortgage interest, deductibility of, **16**:48
Moving expense deduction, expatriates and, **17**:26
Moving expenses, **17**:25–27
  distance test, **17**:25
  planning strategies for, **17**:27
  time test, **17**:25–26
  treatment of, **17**:26
  what is not included, **17**:27
Multijurisdictional taxation, common challenges of, **13**:29–35
  authority to tax, **13**:29
  division of income **13**:29–30
  interjurisdictional agreements, **13**:34–35
  tax havens, **13**:34
  transfer pricing, **13**:30–33
Multijurisdictional taxpayer, **13**:2–3
Multinational transactions, U.S. taxation of, **13**:3–21
  sources of law, **13**:4–5
  tax issues, **13**:6–21
Multiple support agreement, **16**:15–16
  and the medical expense deduction, planning strategies for, **16**:16
Multistate income taxation, corporate, **13**:29
Multistate Tax Commission (MTC), **13**:22
Municipal bonds, planning strategies for, **4**:23–24

N

Nanny tax, Schedule H, Form 1040, **17**:4
Natural resources, depletion of, **5**:22
Net capital gain, **4**:30, **8**:20
Net capital loss, **4**:31, **8**:20
Net gain, **8**:26
Net income tax, **14**:4
Net investment income, **16**:44
Net loss, **8**:26
Net operating losses (NOLs), **3**:6, **5**:20, **6**:12–14, **12**:22–23
  carryback and carryover periods, **6**:13–14
  deduction, utility of, **6**:12
  tax savings from, **6**:14
Net regular tax liability, **14**:4
Net taxes payable or refund due, computation of, **16**:25–26
Net unearned income, **16**:27
Net worth, change in as a measure of income (or loss), **4**:4
Nexus, **13**:23, **13**:24
No-additional-cost services, **17**:14–15, **17**:20
Nominal property, transfers for, **9**:13–14
Nonaccountable plans, **17**:37
Nonacquiescence (NA or Nonacq.), **2**:16
Nonbusiness bad debt, **6**:4–5
Nonbusiness debt, **6**:3
Nonbusiness expenses, itemized deductions, **16**:36
Noncompliance costs with rental real estate, **6**:30
Noncontingent payments, **8**:12
Noncorporate taxpayers, capital gains of, **8**:19
  tax treatment of, **8**:16–23
Nondeductible contributions, IRA, **17**:39
Nondeductible expenses, **3**:7
Nondeductible items, charitable contributions, **16**:48
Nondiscrimination provisions, **17**:17–18
Nonliquidating property distribution, **10**:25
Nonpersonal-use capital assets, casualty or theft and, Section 1231 assets, **8**:26
Nonrecaptured net Section 1231 losses, **8**:28
Nonrecognition of gain or loss, **7**:7
  certain exchanges of insurance policies—Section 1035, **7**:31
  dispositions of personal-use assets, **7**:7
  exceptions to, **11**:10–11
  exchange of stock for property—Section 1032, **7**:31
  exchange of stock for stock of the same corporation—Section 1036, **7**:31–32
  other, **7**:31–33
  rollovers into specialized small business investment companies—Section 1044, **7**:32
  sale of a principal residence—Section 121, **7**:32
  transfer of assets to business entity—Sections 351 and 721, **7**:31
  transfers of property between spouses or incident to divorce—Section 1041, **7**:33
Nonrecourse debt, **11**:22
Nonresident alien (NRA), **12**:7, **13**:19
Nontax considerations, **9**:7
Nontax factors of business entities, **15**:5–7
  capital formation, **15**:5–6
  limited liability, **15**:6
  other factors, **15**:7
Nontaxable economic benefits, **4**:9
Nontaxable exchange, **7**:20, **8**:13–14
  financial accounting, **7**:5
  general concept of, **7**:18–20
Nontaxable income, **3**:7
Nontaxable stock dividends, **7**:10
Nontaxable transactions
  involving carryover of another taxpayer's basis, **8**:14
  recapture potential of certain, **8**:37
Nursing home care, **16**:38

O

Obligation to repay, amounts received under, **4**:12
Occupational taxes, **1**:14
OECD (Organization for Economic Cooperation and Development), **13**:30
  tax haven blacklist, **13**:33
Office in the home expenses, **17**:33–35
  Form 8829, **17**:34
Offshore profits, **13**:16
On the employer's business premises requirement, **17**:8–9
Ongoing test, for AMT corporate exemption, **14**:13
Online commercial services, **2**:28
Options, **8**:8–10
  exercise of by grantee, **8**:10
  failure to exercise, **8**:9
  sale of, **8**:9
Ordinary and necessary, **5**:3

business expenses, **17**:43
requirement, **5**:3
Ordinary income, **8**:16, **8**:29, **11**:6
property, **5**:15, **16**:50
Ordinary loss, **6**:6
business bad debt, **6**:5
Organizational costs, **11**:15
Organizational expenditures, **9**:30
deduction, **9**:30–31
planning strategies for, **9**:31
Organizational form, choice of when operating overseas, **9**:3
Original issue discount, **4**:11–12
Other adjustments account (OAA), **12**:16, **12**:17
Outbound taxation, **13**:4
Outside basis, **11**:13
Outsourcing of tax return preparation, **1**:29
Ownership interest
disposition of, **15**:21–25
effect on basis of, **15**:16–17
Owner-user or owner-investor, **7**:29

P

Parent-subsidiary controlled group, **9**:33
Partial recapture, **8**:33
Participation
active, **6**:32
defined, **6**:27–28
material, **6**:24–28, **6**:32
tests based on current, **6**:24–26
tests based on prior, **6**:26
Partner and partnership, transactions between, **11**:30–33
guaranteed payments, **11**:30–31
other transactions, **11**:31–32
partners as employees, **11**:32
planning strategies for, **11**:33
Partner's basis, gain and loss, **11**:23–26
capital changes, **11**:25–26
distributions, **11**:24–25
Partner's basis in partnership interest, **11**:25
Partner's ownership interest in a partnership, **11**:8–9
Partners as employees, **11**:32
Partnership activities, tax reporting of, **11**:18
Partnership allocations, **11**:19–20
economic effect, **11**:19–20
precontribution gain or loss, **11**:20
Partnership, basis of a partnership interest, **11**:21–23
partner's basis, gain, and loss, **11**:23–26
partnership liabilities, **11**:22–23
Partnership interest
basis in, **11**:9
basis of, **11**:21–23, **11**:23–26
Partnership liabilities, **11**:22–23
ratable share of, **12**:21
Partnership power, **11**:3
Partnership taxation
and reporting, **11**:5–8
overview of, **11**:2–9
Partnerships, **1**:18, **11**:2, **11**:3, **15**:3–4
advantages and disadvantages of form, **11**:34
around the world, **11**:35
assets of for tax year 2007, **11**:21
conduit approach, **15**:15–16, **15**:18
defined, **11**:4–5
disposition of, **15**:23
distribution of property in-kind, **12**:19
distributions of appreciated property, **15**:19
Form 1065, **1**:18, **11**:7, **15**:4
formation and basis computation, **11**:14
formation and operation, planning strategies for, **11**:29
income tax returns: profits vs. losses, **15**:21
initial costs of, **11**:14–16
loss limitations, **11**:26–29
operations of, **11**:16–29
partnership allocations, **11**:19–20
reporting operating results, **11**:16–19
tax attributes of, **15**:27–30
tax effects in formation of, **11**:9–16
tax treatment of the disposition of, **15**:25
transactions between partner and, **11**:30–33
Passenger automobiles, **5**:33
Passive activity
changes to active, **6**:21
disposition of, **6**:33–34
rules, **11**:29
Passive activity losses (PALs), **6**:34, **14**:23–24
effect on, **15**:19
rules: general concepts, **6**:27
Passive credits, **6**:20–21
carryovers of, **6**:21
Passive income, **6**:16, **6**:18
and loss, classification and impact of, **6**:18–21
generator (PIG), **6**:34
Passive investment holding company, **13**:34
Passive investment income (PII), **12**:10, **12**:29
penalty tax, **12**:28–29
pitfalls, planning strategies to avoid, **12**:29
Passive loss limits, **6**:18–35
activity defined, **6**:23
classification and impact of passive income and loss, **6**:18–21
disposition of passive activities, **6**:33–34
interaction of at-risk and passive activity limits, **6**:29–30
material participation, **6**:24–28
rental activities, **6**:28–29
special rules for real estate, **6**:30–33
taxpayers subject to the passive loss rules, **6**:21–23
Passive loss rules, **6**:15, **11**:26
taxpayers subject to, **6**:21–23
Passive losses
and credits, **12**:24
planning strategies for utilizing, **6**:34–35
Pass-through entities, **11**:3
Patents, **8**:10–11
holder defined, **8**:11
Section 197 intangible, **5**:37
substantial rights, **8**:10–11
Payment of deficiency, **2**:13
Payroll factor, **13**:25
Penalties, **5**:7
failure to disclose, **2**:7
legal expenses incurred in defense of civil or criminal, **5**:8–9
on underpayments, **17**:49–50
Percentage depletion, **5**:38, **5**:39, **14**:16–17
sample of rates, **5**:39
Percentage of completion method, **4**:7
Permanent differences, **3**:6
Permanent establishment (PE), **13**:5
Permanent reinvestment exception, **3**:19
Permanently reinvesting, **3**:17
Personal exemptions, **16**:7, **16**:10–11
deductions from AGI, **1**:15
phaseout of, **16**:18
Personal expenses, itemized deductions, **16**:36
Personal holding company (PHC) tax, **10**:26
Personal injury, **16**:34
Personal interest, deductibility of, **16**:48
Personal property
cost recovery for, **5**:24–28
depreciation of post-1986, AMT adjustments for, **14**:20–21
taxes, **16**:41
Personal service corporations (PSCs), **6**:22, **9**:32, **15**:19
Personal services, **4**:13–14
of an employee, **4**:14
Personalty, **1**:11, **5**:23, **7**:22
cost recovery periods: MACRS, **5**:25
personal-use, **1**:12
taxes on, **1**:12–13
Personal-use assets, **5**:23, **8**:4
converted to business or income-producing use, cost recovery basis for, **5**:24
dispositions of, **7**:7
Personal-use personalty, **1**:12
Personal-use property, **5**:23
partial or complete destruction of, **6**:10
special rule on insurance recovery, **6**:10
Personal-use realty, **1**:12
Petitioner, **2**:24
Phaseout of IRA deduction of an active participant, **17**:39
Planning strategies
accumulated adjustments account, **12**:18
AMT, **14**:28, **15**:10
avoid PII pitfalls, **12**:29
beating the 100 shareholder limit, **12**:7
benefits of Section 1244, **6**:7
built-in gains tax, **12**:27
business incorporations, **9**:23
cash receipts method, **4**:9
choosing a business form, **15**:31
constructive dividends, **10**:19–20, **13**:18
corporate distributions, **10**:11
corporate liquidations, **10**:25–26
deferral and repatriation, **13**:9
depletion methods, **5**:40
depreciation recapture and Section 179, **8**:32
documentation of related-taxpayer loans, and casualty and theft losses, **6**:9
education expenses, **17**:29
entertainment expenses, **17**:32
for gifts, **7**:12, **8**:17
foreign tax credit, **13**:13
holding companies, **13**:34
income of certain children, **16**:28
income shifting, **13**:28, **16**:25
income, where should it go, **13**:28

Planning strategies *(contd.)*
itemized deductions, **16**:53
joint return, **16**:17
life insurance, **4**:26
like-kind exchanges, **7**:21
loss considerations, **12**:23
matching gains with losses, **8**:22
moving expenses, **17**:27
multiple support agreement and the medical expense deduction, **16**:16
nexus, **13**:24
organizational expenditures, **9**:31
partnership, **11**:29
passive losses, **6**:34–35
preferences and adjustments, **14**:24, **14**:28
prepaid income, **4**:13
property from a decedent, **7**:15
recognizing involuntary conversion gains, **7**:28
reducing effective tax rates with ASC 740-30 (APB 23), **3**:19
related groups, check-the-box regulations, **9**:8
retirement plan choices, **17**:47, **17**:48
salary structure, **12**:14
Section 351, **9**:12–13, **9**:18
self-employed individuals, **17**:5
selling depreciable real estate, **8**:36
selling stock or assets, **15**:9, **15**:24
sourcing income from sales of inventory, **13**:10–11
state and municipal bonds, **4**:23–24
stock redemptions, **10**:24
structuring the sale of a business, **5**:37
Subchapter S option, **12**:5, **12**:8, **12**:10, **14**:29
suspended losses, **12**:22
tax savings are not always created equal, **3**:25
tax shelter, **11**:27
techniques for reducing gross income, **4**:17
time value of tax deductions, **5**:5
timing capital gains, **8**:16
timing of recapture, **8**:38
timing the payment of deductible taxes, **16**:43
transactions between partners and partnerships, **11**:33
transportation and travel expenses, **17**:25
treaty shopping, **13**:6
unreasonable compensation, **5**:4
unreimbursed employee business expenses, **17**:38
valuation allowances, **3**:15–16
wash sales, **7**:17
Points, **16**:46
Political considerations, **1**:31–32
political expediency, **1**:32
special interest legislation, **1**:31–32
state and local government influences, **1**:32
tax law, **1**:35
Political contributions, **5**:8
Political expediency, **1**:32
Political science
tax law, **1**:16
taxes and marriage, **1**:33
Pollution control facilities, AMT adjustments for, **14**:21
Portfolio, income, **6**:16, **6**:18
Postelection termination period, **12**:18
Precedents, **2**:15
Precontribution gain or loss, **11**:20
Preferences and adjustments, planning strategies for controlling the timing of, **14**:28
Prepaid income, **4**:12, **4**:13
Prepaid interest, **16**:47
Prepayment penalty, **16**:46
Presumptive rule of Section 183, **17**:50–51
Primary valuation amount, **7**:14
Principal residence, sale of, **7**:32
Prior participation, tests based on, **6**:26
Private activity bonds, **14**:18
Private entity becomes a public corporation, **8**:4
Private Letter Rulings, **2**:10
Prizes and awards, **16**:30–31
Pro rata basis allocation of current E & P, **10**:7
Procedural matters, **9**:34–38
estimated tax payments, **9**:34–35
filing requirements for corporations, **9**:34
Schedule M-1, reconciliation of taxable income and financial net income, **9**:35–37
Schedule M-3, net income (loss) reconciliation for corporations with total assets of $10 million or more, **9**:37–38
Procedural Regulations, **2**:23
Product class, **7**:22
Production activities, **5**:20
Production and sale of goods, taxes on, **1**:5–7
Profit and loss sharing ratios, **11**:8
Profits (loss) interest, **11**:8
Progressive (or graduated) rate, **16**:25
Progressive tax rate, **1**:3
Property, **9**:10
appreciated or depreciated, **7**:24, **15**:19
bargain purchase of, **7**:8
bargain rental of corporate, **10**:16
bargain sale of corporate to a shareholder, **10**:16
basis adjustment for loss, **9**:20–22
basis of like-kind, **7**:25
business or investment, partial destruction of, **6**:10
capital gain, **16**:50
complete destruction of business or investment, **6**:10
conversion from personal use to business or income-producing use, **7**:17–18
cost recovery for personal, **5**:24–28
definition for Section 351 purposes, **9**:10
depreciable real, **8**:33
determining the deduction for contributions of by individuals, **16**:51
exchange of stock for, **7**:31
expenses related to management of, **16**:36
income from, **4**:14–17
inherited, **8**:15
intangible real, **8**:33
nature of, **5**:23
ordinary income, **16**:50
personal, depreciation of post-1986, AMT adjustments for, **14**:20–21
personal-use, **5**:23, **6**:10
real, depreciation of post-1986, AMT adjustments for, **14**:19–20
replacement, **7**:29–30
sale or other disposition of, **7**:3, **11**:31–32
Section 1231 assets, **8**:25, **8**:26
shareholder use of corporate-owned, **10**:15–16
tangible personal, **5**:31
transfer of, **9**:10–11
transfers for, **9**:13
Property acquired from a decedent, **7**:14–16
deathbed gifts, **7**:15
holding period of, **7**:16
planning strategies for, **7**:15
Property contributions, **5**:15–16
Property distributions by the corporation, tax treatment of, **12**:19–20
Property dividend, **10**:12–15
effect on the corporation, **10**:13–15
effect on the shareholder, **10**:12–13
Property factor, **13**:25
Property in-kind, distribution of, **12**:19
Property received
basis and holding period of, **7**:25–26
corporation's basis in, **9**:20
Property taxes, **1**:11–13
on personalty, **1**:12–13
on realty, **1**:11–12
Property to corporation, basis of, **9**:19–20
Property transactions, gains and losses from, **4**:29–31
Proportional tax rate, **1**:3
Proposed Regulations, **2**:8
Proprietor, **17**:2
Proprietorship, **1**:17–18
Schedule C, Profit or Loss from Business of Form 1040, **1**:18
See also Sole proprietorship
Prospect of full recovery, **6**:8
Public corporation, private entity becomes, **8**:4
Public Law 86-272, **13**:22, **13**:23
Public policy, **2**:18
Public policy limitations, **5**:7–8
expenses related to an illegal business, **5**:9
justification for denying deductions, **5**:7
legal expenses incurred in defense of civil or criminal penalties, **5**:8–9
Publicly held corporations, **5**:9
Publicly traded companies, dividend cuts by, **10**:13
Publicly traded corporation, **8**:4
Punitive damages, **16**:34

Q

Qualified bicycle commuting reimbursement, **17**:17
Qualified child care expenses, **14**:12
Qualified dividends, **4**:16
Qualified employee discounts, **17**:14, **17**:15–16
on goods and services, **17**:20
Qualified expenditures, **17**:20
Qualified fringe benefits, advantages of, **17**:5–6
Qualified moving expenses, **17**:26
reimbursements, **17**:14, **17**:17, **17**:20

Qualified nonrecourse debt, **11**:29
Qualified nonrecourse financing, **6**:17
Qualified organizations, **5**:14
Qualified plan award, **16**:31
Qualified production activities income (QPAI), **5**:20, **5**:21, **11**:18
  calculation of, **5**:21–22
  eligible taxpayers, **5**:22
Qualified production property (QPP), **5**:21
Qualified property, **5**:26
Qualified real property business indebtedness, **4**:27
Qualified real property indebtedness, **4**:28
Qualified residence, **16**:45
  interest, **16**:45–46
Qualified retirement planning services, **17**:14, **17**:17, **17**:20
Qualified small business stock, **8**:18, **8**:22
Qualified transportation fringes, **17**:14, **17**:17, **17**:20
Qualified tuition deduction, rules for, **17**:30
Qualified tuition reduction plans, **17**:11
Qualifying child, **16**:12, **16**:58
  abode test, **16**:12
  age test, **16**:12
  relationship test, **16**:12
  support test, **16**:12–13
  tiebreaker rules, **16**:13
Qualifying relative, **16**:13–16
  gross income test, **16**:14
  relationship test, **16**:13–14
  support test, **16**:14–16

R

Rate reconciliation, **3**:20
Rates for heads of household, **16**:22–23
Rates for married individuals, **16**:21–22
Rates for single taxpayers, **16**:21
Ratios
  capital sharing, **11**:8
  profit and loss sharing, **11**:8
Real estate (realty), **7**:21–22
  cost recovery for, **5**:28
  planning strategies for selling depreciable, **8**:36
  professionals, **6**:30–31
  special rules for, **6**:30–33
  taxes, **16**:41–42
  See also Realty
Real property
  depreciable, **8**:33
  depreciation of post-1986, AMT adjustments for, **14**:19–20
  intangible, **8**:33
  subdivided for sale, **8**:6–7
  taxes standard deductions, **16**:9
Realization, **4**:19
Realized gain, **4**:29–30, **7**:3–6
  adjusted basis, **7**:4
  amount realized, **7**:3–4
  capital additions, **7**:4–5
  capital recoveries, **7**:5–6
  sale or other disposition of property, **7**:3
Realized loss, **4**:29–30, **7**:3–6
  adjusted basis, **7**:4
  amount realized, **7**:3–4
  capital additions, **7**:4–5
  capital recoveries, **7**:5–6
  sale or other disposition of property, **7**:3
Realty, **1**:11, **5**:23
  business-use, **1**:12
  personal-use, **1**:12
Reasonableness, **15**:11
  requirement, **5**:3–4
Recapture
  considerations, **9**:23
  of tax credit for rehabilitation expenditures, **14**:6–7
  planning for the timing of, **8**:38
  provisions in Sections 1245 and 1250, **8**:3
Receivables, tax issues related to contributed property, **11**:12–13
Recognized gain, **4**:29–30, **7**:6–7
Recognized loss, **4**:29–30, **7**:6–7
Record-keeping requirements for charitable contributions, **16**:49
Recourse debt, **11**:22
Recoveries of capital, **7**:4
Recovery of capital doctrine, **7**:7–8
Recurring items, **5**:6
Reelection after termination, **12**:10
Refund due, computation of, net taxes payable or, **16**:25–26
Regressive tax rate, **1**:3
Regular corporations, **9**:3
  See also C corporations
Regular decisions, **2**:16
Regular tax liability, **14**:4
Regulation and oversight, **2**:31
Rehabilitation expenditures, **14**:14
  credit, **14**:5–7
  credit recapture, **14**:6–7
Related corporations, **9**:32
Related groups, planning strategies for utilizing check-the-box regulations, **9**:8
Related parties
  interest paid to, **16**:46
  like-kind exchanges, **7**:23
  loans between, **6**:5–6
Related taxpayers, **7**:16
Related-party transactions, **5**:11–13
  losses, **5**:11–12
  relationships and constructive ownership, **5**:12–13
  unpaid expenses and interest, **5**:12
Related-taxpayer loans, planning strategies for documentation of, **6**:9
Relationship test
  for qualifying child, **16**:12
  for qualifying relative, **16**:13–14
  multiple support agreement and, **16**:15
Relationships and constructive ownership in transactions between related parties, **5**:12–13
Rent or royalty expenses, Schedule E, **16**:47
Rent, when it is active rather than passive, **15**:20
Rental activity, **6**:28–29
Rental real estate
  deduction, **6**:32–33
  noncompliance costs with **6**:30
Replacement property, **7**:29–30
  functional use test, **7**:29
  special real property test, **7**:30
  taxpayer use test, **7**:29–30
  tests, **7**:30
Reporting procedures, **8**:38
Required as a condition of employment test, **17**:9
Research activities credit, **5**:17, **14**:8–10, **14**:14
  basic research credit, **14**:10
  energy research credit, **14**:10
  incremental research activities credit, **14**:8–9
Research and experimental expenditures, **5**:17–18
  deferral and amortization method of, **5**:18
  expense method of, **5**:17
Research expenditures, **14**:8
Reserve method, **6**:3
Reserves, **5**:6
Residential rental real estate, **5**:28
Respondent, **2**:24
Retirement plan choices, planning strategies for, **17**:48
Retirement plans for self-employed individuals, **17**:45–48
  Keogh plans, **17**:45–46
  SIMPLE plans, **17**:47–48
Returns filed by number of S corporation shareholders, 2006 tax year, **12**:13
Revenue neutral, **2**:20
Revenue neutrality, **2**:18
Revenue Procedures, **2**:9–10
Revenue relevance of corporate vs. individual taxpayers, **15**:5
Revenue Rulings, **2**:9–10
Revenues
  finding new, **13**:30
  sources of Federal government, **9**:36
Right of offset, **7**:16
Rollovers into specialized small business investment companies—Section 1044, **7**:32
Roth IRAs, **17**:40–41

S

S corporation economy, **12**:30
S corporation losses, treatment of, **12**:25
S corporation returns filed (%), 2006 tax year, **12**:3
S corporation shareholders
  flow-through of separate items of income and loss to, **12**:11
  returns filed by number of, 2006 tax year, **12**:13
S corporation status
  definition of a small business corporation, **12**:4–7
  electing, **15**:14–15
  Form 2553, **12**:7
  loss of the election, **12**:8–10
  making the election, **12**:7–8
  planning strategies on when to elect, **12**:5
  qualifying for, **12**:4–11
  shareholder consent, **12**:8

S corporations, **1**:18–19, **9**:3, **11**:3, **12**:2, **15**:3–4
an overview, **12**:3–4
business of, **12**:3
conduit concept, **15**:18
disposition of, **15**:24–25, **15**:26
distribution of property in-kind, **12**:19
distributions from, **12**:15
Form 1120S, **1**:18, **11**:16, **12**:6, **15**:4
LLC advantages over, **15**:4
operational rules, **12**:11–25
tax attributes of, **15**:27–30
S election
effects of terminating, **12**:18
Form 2553, **12**:7, **12**:8
planning strategies for, **12**:8, **12**:10
Safe harbor provisions, **12**:6
Salary structure, planning strategies for, **12**:14
Sale of a business, planning strategies for, **5**:37
Sale of a principal residence, **7**:32
Sale of goods, taxes on the production and, **1**:5–7
Sale or exchange, **8**:7–13
franchises, trademarks, and trade names, **8**:11–12
lease cancellation payments, **8**:12–13
options, **8**:8–10
patents, **8**:10–11
retirement of corporate obligations, **8**:8
worthless securities and Section 1244 stock, **8**:8
Sale or other disposition of property, **7**:3
Sales factor, **13**:25
Sales of property, **11**:31–32
Sales taxes, **1**:3
state and local, **16**:42–43
Sales/use tax on Internet sales, **13**:31
Sarbanes-Oxley, **4**:19
Savings incentive match plan for employees. *See* SIMPLE plan
Schedule A, Itemized Deductions, Form 1040, **16**:47, **17**:3
Schedule C, Profit or Loss from Business, Form 1040, **1**:18, **15**:3, **16**:47, **17**:3, **17**:42
Schedule E, **16**:47
Schedule H, Form 1040, nanny tax, **17**:4
Schedule K, Form 1065, **11**:7
Schedule K-1, partnerships, **11**:7
Schedule L, Standard Deduction for Certain Filers, **16**:9, **11**:7–8
Schedule M-1, **3**:6, **3**:7–8, **9**:35–37, **11**:7–8
Schedule M-2, **9**:36–37, **11**:8, **12**:16, **12**:17–18
Schedule M-3, **3**:6, **3**:8, **9**:37–38, **11**:7–8
Schedule SE, Form 1040, **1**:8
SCHIP (State Children's Health Insurance Program), **1**:5
Scholarships, **16**:32–33
disguised compensation, **16**:33
timing issues, **16**:33
Section 61, broad definition of gross income, **1**:20, **4**:3, **4**:4, **17**:43
Section 121, sale of a principal residence, **7**:32
Section 162, business deductions, **5**:3, **17**:43
Section 174, research and experimental expenditures, **5**:17–18
Section 179 expensing election, **5**:31, **8**:32, **9**:32, **10**:6
Election to Expense Certain Depreciable Business Assets, **5**:31–32
Section 199, domestic production activities deduction, **11**:18–19
Section 262, sale or exchange of personal-use assets, **8**:14
Section 267, sale or exchange between related taxpayers, **5**:12–13, **7**:16, **8**:14
Section 274, substantiation requirements, **5**:36
Section 351, transfer of assets to business entity, **7**:31, **9**:9, **9**:10, **9**:11, **9**:12–13, **9**:15, **9**:18, **9**:20
Section 357, assumption of liabilities, **9**:15–17
Section 367, tainted assets under, **9**:15
Section 469, passive income, **6**:18
Section 482, application of, **9**:34
Section 721, transfer of assets to business entity, **7**:31
Section 1031, like-kind exchanges, **9**:8–9, **7**:20–26
Section 1032, exchange of stock for property, **7**:31
Section 1033, involuntary conversions, **7**:27–31
Section 1035, certain exchanges of insurance policies, **7**:31
Section 1036, exchange of stock for stock of the same corporation, **7**:31–32
Section 1041, transfers of property between spouses or incident to divorce, **7**:33
Section 1044, rollovers into specialized small business investment companies, **7**:32
Section 1221 property, **4**:30
Section 1231 assets, **8**:3, **8**:25–29
Section 1231 gains and losses, **8**:25
Section 1231 lookback, **8**:28–29
Section 1231 netting procedure, **8**:27–28, **8**:30
Section 1231 property, **8**:25
Section 1244 provisions, **1**:24
Section 1244 stock, **6**:6, **6**:7, **8**:8
Section 1245 property, **8**:31
Section 1245 recapture, **8**:3, **8**:29–32, **8**:34, **8**:35–37
Section 1250 property, **8**:33
Section 1250 recapture, **8**:3, **8**:32, **8**:33–35, **8**:35–37
Securities, **9**:11
dealers in, **8**:6
holding period of new, **7**:17
options, **8**:9
substantially identical, **2**:25
tax-exempt, **16**:46
Securities and Exchange Commission (SEC), **2**:31, **3**:5, **3**:28, **9**:38
Seeking employment, expenses incurred in, **17**:36
Self-directed retirement plan, **17**:45
Self-employed individuals
employee vs., **17**:3–5
misclassification can be costly, **17**:4
planning strategies for, **17**:5
retirement plans for, **17**:45–48
Schedule C of Form 1040, **17**:3
Self-employment
Schedule SE of Form 1040, **1**:8
tax, **1**:8, **17**:5, **17**:43–45
Seller cancellation, **4**:28–29
Senate, **2**:3–5
Senate Finance Committee, **2**:4–5
Separate foreign tax credit limitation categories, **13**:13
Separately stated items, **11**:6
Series EE savings bonds, **16**:35
Service firms and organizational form, **15**:4
Services, **9**:10, **11**:11
contribution of, **16**:48
deferral of advance payments for, **4**:13
interest paid for, **16**:46
no-additional-cost, **17**:14–15
of an employee, **4**:14
placed in service requirement, **5**:23
rendered, stock issued for, **9**:22
transfers for, **9**:13–14
Severance taxes, **1**:14
SFAS 109, **3**:4
Share-Based Payment, Statement of Financial Accounting Standards No. 123R, **3**:5
Shared operating arrangement, **11**:2
Shareholder cancellation, **4**:29
Shareholder consent, S corporation status, **12**:8
Shareholder limitations, type of, **12**:6–7
Shareholder use of corporate-owned property, **10**:15–16
Shareholders
accumulated adjustments account, **12**:16–17
effect of property dividends on, **10**:12–13
effects of terminating the S election, **12**:18
flow-through of separate items of income and loss to S corporation, **12**:11
loans to, **10**:16–17
loans to a corporation by, **10**:18
number of, **12**:6
other adjustments account, **12**:17
payments for the benefit of, **10**:16
S corporation with AEP, **12**:15–16
S corporation with no AEP, **12**:15
Schedule M-2, **12**:17–18
tax consequences to, with and without the application of Section 351, **9**:20
tax treatment of distributions to, **12**:15–18
U.S., **13**:15
Shareholder's basis, **12**:20–22
in stock received, **9**:19
Short sales, **7**:8, **8**:15
Short-term capital loss, nonbusiness bad debt, **6**:5
Short-term gains, **8**:16
Short-year election, **12**:13–14
Significant participation activity, **6**:25
SIMPLE plans, **17**:47–48
Single taxpayers
rates for, **16**:21
2010 tax rate schedule for, **16**:24
Single vs. double taxation, **15**:7–10
Small business corporation, **12**:4, **12**:13
ineligible corporations, **12**:5
loss of status, **12**:9
nonresident aliens, **12**:7
number of shareholders, **12**:6

one class of stock, **12**:6
type of shareholder limitations, **12**:6–7
Small business stock (Section 1244 stock), **6**:6, **8**:22–23
Small Cases Division of the Tax Court, **2**:11
Social considerations, **1**:29–30
tax law, **1**:35
Social security benefits, **16**:31
appropriate age for, **16**:31
Sociology
tax law, **1**:16
taxes and marriage, **1**:33
Sole proprietor
Schedule C of Form 1040, **17**:42
unlimited liability, **9**:7
Sole proprietorship, **15**:3–4
as a business entity, **17**:42–43
disposition of, **15**:22, **15**:25
health insurance premiums, deductions related to, **17**:43
income of, **17**:43
ordinary and necessary business expenses, deductions related to, **17**:43
Schedule C of Form 1040, **15**:3
self-employment tax, deductions related to, **17**:43–45
tax attributes of, **15**:27–30
Solicitation, **13**:22
Special allocation, **11**:8
effect of, **15**:20–21
Special clothing, deductibility of, **17**:36
Special holding period rules, **8**:13–15
disallowed loss transactions, **8**:14
inherited property, **8**:15
nontaxable exchanges, **8**:13–14
nontaxable transactions involving carryover of another taxpayer's basis, **8**:14
Special interest legislation, **1**:31–32
Special purpose entities, **3**:3
Special real property test, **7**:30
Specialized small business investment company (SSBIC), **7**:32
Specific charge-off method, **6**:3–4
tax treatment of bad debts, **6**:5
Spousal IRAs, **17**:38
Spouse and dependents, medical expenses for, **16**:39
Spouses or incident to divorce, transfers of property between, **7**:33
Standard deduction, **1**:15, **16**:7, **16**:8–10
basic amounts, **16**:8
real property taxes and auto sales taxes, **16**:9
special limitations for dependents, **16**:10
Standard Federal Tax Reporter, **2**:21
Start-up costs, **11**:15–16
Start-up expenditures, **9**:31
State and local government influences, **1**:32
State and local income taxation in the U.S., crossing state lines, **13**:20–29
sources of law, **13**:21–23
tax issues, **13**:23–28
State and municipal bonds, planning strategies for, **4**:23–24
State death taxes, **1**:9
State deficits change how revenue departments work, **13**:27
State excise taxes, **1**:5–6
State gift taxes, **1**:11
State income tax liability, computing, **13**:25
State income taxes, **1**:16
State tax revenue sources, **13**:22
State taxation, **15**:10
Statement of Financial Accounting Standards No. 123R—*Share-Based Payment*, **3**:5
Statutory depletion, **5**:39
Statutory expansions
dealers in securities, **8**:6
real property subdivided for sale, **8**:6–7
Statutory (or nominal) rates, **16**:24
Statutory percentage method
listed property predominantly used for business, **5**:32
MACRS computational rules, **5**:29
Statutory sources of tax law, **2**:3–7
arrangement of the code, **2**:5–6
citing the code, **2**:6–7
effect of treaties, **2**:7
legislative process, **2**:3–5
origin of the Internal Revenue Code, **2**:3
Stealth tax, **16**:19
Stepped-down basis, **7**:14
Stepped-up basis, **7**:14
Stock, **9**:11
basis of, to shareholder, **9**:18–19
for property, exchange of, **7**:31
for stock of the same corporation, exchange of, **7**:31–32
holding period of new, **7**:17
one class of, **12**:6
planning strategies for selling, **15**:24
substantially identical, **2**:25
vs. corporate assets, planning strategies for selling, **15**:9
Stock dividends, **10**:20–21
Stock issued for services rendered, **9**:22
Stock options, **8**:9
Stock received, shareholder's basis in, **9**:19
Stock redemptions, **10**:21–24
foreign shareholders prefer sale or exchange treatment in, **10**:24
planning strategies for, **10**:24
Straight-line depreciation, **10**:5
Straight-line election, **5**:29
Straight-line method
depreciation on fixed assets, **3**:6
election of, **5**:25
listed property not predominantly used for business, **5**:32
MACRS computational rules, **5**:29
Student loans, **4**:29
Subchapter C, Corporate Distributions and Adjustments, **2**:6
Subchapter K, Partners and Partnerships, **2**:6
Subchapter S, Tax Treatment of S Corporations and Their Shareholders, **2**:6, **12**:2, **14**:29
Subpart F income, **13**:14
Subprime mortgage debacle, **4**:28
auto maker hurt by, **3**:15
losses on, **8**:7
Substantial rights, patents, **8**:10–11
Substantially identical, **7**:16, **8**:15
stock or securities, **2**:25
Substantially rehabilitated, **14**:6
Substantiation
lack of adequate, **5**:13
requirements, **5**:36
Substituted basis, **11**:12
Sudden event, casualty loss, **6**:7
Support test
for qualifying child, **16**:12–13
for qualifying relative, **16**:14–16
Supreme Court, **2**:15
judicial citations of, **2**:18
Supreme Court Reporter (S.Ct.), **2**:18
Surviving spouse, **16**:22
Suspended losses
carryovers of, **6**:20
impact of, **6**:19–20
planning strategies for, **12**:22
Syndication costs, **11**:15

T

Tables, cost recovery, **5**:40–44
Tainted assets, **9**:15
Tangible assets, write-off of, **5**:22
Tangible personal property, **5**:31
Tangible property, **1**:12
Tariffs, **1**:13
Tax accounting elections, **11**:14
Tax attributes of different forms of business, **15**:27–30
Tax avoidance, **1**:20
loans, imputed interest rules, **4**:20
or no bona fide business purpose, **9**:15–16
Tax bases, **1**:4
Tax benefit rule, **4**:22
applying, **6**:4
Tax, book vs., **3**:8
Tax burden, **1**:3
determining, **1**:26–27
U.S., **1**:13
Tax compliance, what form of, **16**:21
Tax concepts of income, comparison of accounting and, **4**:6
Tax consequences to the shareholders and corporation with and without the application of Section 351, **9**:20
Tax conventions, **2**:7
Tax Court, **2**:11, **2**:12–13, **2**:13–15
judicial citations of, **2**:16–17
jurisdiction of, **2**:13
See also Courts
Tax Court of the United States Reports (T.C.), **2**:16
Tax credits, **3**:7, **14**:2–3, **14**:14–15, **16**:25–26
adoption expenses credit, **16**:53–54
child tax credit, **16**:54
credit for child and dependent care expenses, **16**:54–56
credit for employer-provided child care, **14**:11, **14**:15
credit for small employer pension plan startup costs, **14**:11, **14**:14
disabled access credit, **14**:2, **14**:10–11, **14**:14
earned income credit, **16**:58–59
education tax credits, **16**:56–58
energy credits, **14**:14
for individuals, **16**:53–59

Tax credits *(contd.)*
foreign tax credit, **14**:2, **14**:12–13, **14**:15
general business credit, **14**:3–5, **14**:14
jobs credit, **14**:10
low-income housing credit, **14**:14
rehabilitation expenditures credit, **14**:5–7, **14**:14
research activities credit, **14**:8–10, **14**:14
specific business-related provisions, **14**:3–13
tax minimization strategies related to, **1**:25–26
unified transfer tax credit, **1**:9
vs. income tax deduction, **14**:2
work opportunity credit, **14**:7–8, **14**:14
Tax deductions, **16**:25
Tax deferral, **4**:9
Tax determination
computation of net taxes payable or refund due, **16**:25–26
computation procedures, **16**:23–28
filing considerations, **16**:18–23
unearned income of children taxed at parent's rate, **16**:26–28
Tax disclosures in the financial statements, **3**:19–25
Tax evasion, **1**:20
Tax file memorandum, **2**:26
Tax formula, **4**:3–4
adjusted gross income (AGI), **16**:5–6, **16**:6–7
components of, **4**:3–4
deductions, **4**:3–4
determining the tax, **4**:4
exclusions, **4**:3, **16**:4
gross income, **4**:3, **16**:4–5
income (broadly conceived), **4**:3, **16**:3–4
individual, **16**:3–8
itemized deductions, **16**:7
personal and dependency exemptions, **16**:7
standard deduction, **16**:7, **16**:8–10
taxable income, **16**:7–8
Tax Foundation, **1**:34, **16**:4, **16**:26
Tax Freedom Day, **1**:13
Tax gap, **4**:6, **17**:44
Tax haven
OECD's blacklist, **13**:33
multijurisdictional taxation, **13**:34
Tax home, determining for travel expenses, **17**:23
Tax incentives, **5**:27
Tax issues
authority to tax, **13**:6–8
controlled foreign corporations, **13**:14–18
crossing state lines, **13**:23–28
foreign tax credit, **13**:11–14
inbound issues, **13**:19–21
income sourcing, **13**:8–11
multinational transactions, **13**:6–21
Tax issues related to contributed property, **11**:11–13
depreciation method and period, **11**:12
intangible assets, **11**:12
receivables, inventory, and losses, **11**:12–13
Tax law
economic considerations, **1**:28–29, **1**:35
equity considerations, **1**:30–31
influence of the courts on, **1**:34–35
IRS influence of, **1**:33–34, **1**:35
political considerations, **1**:31–32, **1**:35
primary sources of, **2**:24
revenue needs, **1**:27–28
rules of, **2**:2
social considerations, **1**:29–30, **1**:35
tax sources, **2**:2–18
understanding the federal, **1**:27–35
Tax law equity considerations, **1**:35
Tax law sources, **2**:2–18
administrative, **2**:7–11
assessing for tax research, **2**:21–24
judicial, **2**:11–18
statutory, **2**:3–7
tax periodicals, **2**:21
working with tax services, **2**:21
Tax liability of related corporations, **9**:32–33
Tax loopholes, **1**:33
Tax Management Portfolios, **2**:21
Tax minimization strategies related to
credits, **1**:25–26
deductions, **1**:22
income, **1**:20–22
tax rates, **1**:23–25
Tax Notes, **2**:10
Tax on pre-election built-in gain, **12**:25–28
general rules, **12**:26–27
LIFO recapture tax, **12**:28
Tax payments, estimated, **17**:48–50
for individuals, **17**:49
penalty on underpayments, **17**:49–50
Tax periodicals, **2**:21
Tax planning fundamentals, **1**:19–27
Tax planning, overview of, **1**:19–20
Tax policy, **14**:2–3
Tax preference items, **14**:16
Tax preferences, **14**:16–18
interest on private activity bonds, **14**:17–18
percentage depletion, **14**:16–17
planning strategies for avoiding, **14**:24
Tax rate reconciliation for Sears and Wal-Mart, **3**:26
Tax Rate Schedule, **16**:21, **16**:22, **16**:23, **16**:25
for single taxpayers (2010), **16**:24
method, **16**:24–25
Tax rates, **1**:3–4
average, **1**:26
effective, **1**:26
marginal, **1**:26
progressive, **13**
proportional, **1**:3
regressive, **1**:3
tax minimization strategies related to, **1**:23–25
Tax Reform Act of 1986, **9**:31, **12**:3
Tax reporting of partnership activities, **11**:18
Tax research, **2**:18–29
arriving at the solution or at alternative solutions, **2**:25
assessing tax law sources, **2**:21–24
communicating, **2**:25–26
computer's and, **2**:26–29
follow-up procedures, **2**:26
identifying the problem, **2**:19
locating the appropriate tax law sources, **2**:21
on the CPA examination, **2**:29–30
process, **2**:19
refining the problem, **2**:20
Tax return preparation, outsourcing of, **1**:29
Tax reversal: state governments pay for jobs, **15**:17
Tax savings
from NOLs, **6**:14
planning strategies for, **3**:25
Tax services
electronic, **2**:27–28
working with, **2**:21
Tax shelter, **6**:14–16, **6**:22, **12**:14
planning strategies for, **11**:27
transactions, **3**:9
Tax system, costs of complexity of, **1**:34
Tax Table, **16**:24, **16**:25
method, **16**:24
Tax treaties, **2**:6
Tax treatment of bad debts using the specific charge-off method, **6**:5
Tax treatment of capital gains and losses
of corporate taxpayers, **8**:24–25
of noncorporate taxpayers, **8**:16–23
Tax treatment of disposition of a business, **15**:25–26
Tax treatment of distributions to shareholders, **12**:15–18
accumulated adjustments account, **12**:16–17
effects of terminating the S election, **12**:18
other adjustments account, **12**:17
S corporation with AEP, **12**:15–16
S corporation with no AEP, **12**:15
Schedule M-2, **12**:17–18
Tax treatment of property distributions by the corporation, **12**:19–20
Taxable estate, **1**:9
Taxable fringe benefits, **17**:18
Taxable income
additions to, **10**:4
and financial net income, reconciliation of, **9**:35–37
computation of, **12**:11–12
of corporations, **14**:15
self-employment tax, **17**:44
subtractions from, **10**:4
Taxable year, **4**:7
Taxation
general scheme of, **8**:3
incidence of, **1**:4
of damages, **16**:35
of multinational transactions, U.S., **13**:3–21
single vs. double, **15**:7–10
Taxes, **16**:41–43
ad valorem, **1**:11
book-tax differences, **3**:5
death, **1**:9–10
deductibility of, **5**:19–20
deductible and nondeductible, **16**:42, **16**:43
determining, **4**:4
employment, **1**:3, **1**:8–9
entity-level, **12**:25–29
estate, **1**:9
excise, **1**:4, **1**:5–6
explicit, **1**:27
federal collections, **1**:12
FICA, **1**:8
flat, **1**:3

foreign, **16**:43
franchise, **1**:14
FUTA, **1**:8
gift, **1**:3, **1**:10–11
implicit, **1**:27
income, **1**:14–17, **16**:42–43
inheritance, **1**:9
occupational, **1**:14
personal property taxes, **16**:41
property, **1**:11–13
real estate taxes, **16**:41–42
sales, **1**:3, **1**:6–7, **16**:42–43
self-employment, **1**:8, **17**:43–45
severance, **1**:14
stealth, **16**:19
structure of, **1**:2–4
types of, **1**:4–17
unemployment, **1**:8–9
use, **1**:7
value added tax, **1**:7
Taxes on personalty, **1**:12–13
Taxes on privileges and rights, **1**:13–14
federal customs duties, **1**:13–14
franchise taxes and occupational taxes, **1**:14
severance taxes, **1**:14
Taxes on realty, **1**:11–12
Taxes on the production and sale of goods, **1**:5–7
Federal excise taxes, **1**:5
general sales tax, **1**:6–7
local excise taxes, **1**:6
state excise taxes, **1**:5–6
use taxes, **1**:7
value added tax (VAT), **1**:7
Tax-exempt income, expenses and interest related to, **5**:13–14
Tax-exempt securities, **16**:46
Tax-free transaction, **7**:20
Taxpayer, multijurisdictional, **13**:2–3
Taxpayer use test, **7**:29–30
Tax-related websites, **2**:29
Technical Advice Memoranda (TAMs), **2**:11
Telecommuting (or working at home), **17**:36
Temporary assignments, travel expenses, **17**:22–23
Temporary differences, **3**:6
Temporary Regulations, **2**:8
Ten percent ceiling, **5**:16
Tentative minimum tax, **14**:4
Territorial system approach to taxation, **16**:6
Theft losses, **6**:7–12
definition of theft, **6**:8
individual, **6**:11–12
measuring the amount of loss, **6**:9–11
planning strategies for documentation of, **6**:9
Theft or casualty and nonpersonal-use capital assets, Section 1231 assets, **8**:26
Thefts, capital recoveries, **7**:5
Thin capitalization, **9**:27
Thirty percent ceiling on charitable contributions, **16**:50–51
Throwback rule, **13**:27
Tiebreaker rules, for qualifying child, **16**:13
Time limitation on replacement, **7**:30–31
Time test, **17**:25–26
Time value of tax deductions, planning strategies for, **5**:5
Timing
adjustments, E & P, **10**:5
differences, AMT adjustments for, **14**:15
effect on recognition of contribution to the entity, **15**:15–16
effect on recognition of distribution, **15**:18–19
issues, scholarships, **16**:33
of capital gains, planning strategies for, **8**:16
of deduction of charitable contributions, **16**:49
of expense recognition, **5**:5–6
of preferences and adjustments, planning strategies for controlling, **14**:28
of recapture, planning strategies for, **8**:38
of recognition of theft losses, **6**:8
payment of deductible taxes, planning strategies for, **16**:43
Trade names, **8**:11–12
contingent payments, **8**:12
noncontingent payments, **8**:12
Section 197 intangible, **5**:37
significant power, right, or continuing interest, **8**:11
Trade or business expenses, deductions for AGI, **16**:36
Trademarks, **8**:11–12
contingent payments, **8**:12
noncontingent payments, **8**:12
Section 197 intangible, **5**:37
significant power, right, or continuing interest, **8**:11
Transfer pricing, multijurisdictional taxation, **13**:30–33
Transfers of property between spouses or incident to divorce, **7**:33
Transportation and lodging, medical expenses for, **16**:39
Transportation expenses, **17**:20–21
commuting expenses, **17**:21
computation of automobile expenses, **17**:21
planning strategies for, **17**:25
qualified expenditures, **17**:20
Travel expenses, **17**:22–24
away-from-home requirement, **17**:22
combined business and pleasure travel, **17**:23–24
determining the tax home, **17**:23
planning strategies for, **17**:25
temporary assignments, **17**:22–23
Treasury Decisions (TDs), **2**:11
Treasury department regulations, **2**:7–9
Treasury Inspector General for Tax Administration, **7**:23
Treasury regulation, assessing the significance of, **2**:22–23
Treaties, effect of, **2**:7
Treaty shopping, planning strategies, **13**:6
Trial courts, **2**:12–13
federal judicial system, **2**:14
Troubled Assets Relief Program (TARP), **5**:9, **5**:10
Twenty percent ceiling on charitable contributions, **16**:51
Twenty-eight percent property, **8**:18
gain, **8**:20
Twenty-factor test, **17**:4
Two percent floor, miscellaneous itemized deductions subject to, **16**:52

U

U.S. government publications, definition of capital asset, **8**:4U., **8**:6
U.S. income tax treaties in force, **13**:5
U.S. shareholder, **13**:15
U.S. Supreme Court rules on state taxation of other states' interest, **4**:22
U.S. Tax Cases (USTC), **2**:17
U.S. Tax Court, **http://www.usataxcourt.gov**, **2**:16
U.S. tax rules, corporations seeking a vacation from, **13**:33
U.S. tax system, scope of, **2**:3
U.S. tax treatment of foreign person's income, **13**:20
U.S. taxation of multinational transactions, **13**:3–21
sources of law, **13**:4–5
tax issues, **13**:6–21
UDITPA (Uniform Division of Income for Tax Purposes Act), **13**:22
Unearned income, **16**:26
Unearned income of children taxed at parent's rate, **16**:26–28
election to report certain unearned income on parent's return, **16**:27–28
net unearned income, **16**:27
Unemployment compensation, **16**:31
Unemployment taxes, **1**:8–9
Form 940, Employer's Annual Federal Employment Tax Return, **1**:9
Unexpected event, casualty loss, **6**:7
Unified transfer tax credit, **1**:9
Unitary approach, **13**:28
United States Board of Tax Appeals Reports (B.T.A.), **2**:16
United States Reports, Lawyer's Edition (L.Ed.), **2**:18
United States Supreme Court Reports (U.S.), **2**:18
United States Tax Reporter, **2**:21
Unlimited liability, **9**:7
Unpaid expenses and interest in transactions between related parties, **5**:12
Unreasonable compensation, **10**:16, **15**:12
planning strategies for, **5**:4
Unrecaptured Section 1250 gains, **8**:18, **8**:20, **8**:33–34
Unreimbursed employee business expenses, planning strategies for, **17**:38
Unreimbursed expenses, **17**:38
Unrelated use, charitable contributions, **5**:15
Unusual event, casualty loss, **6**:7
Use or lose plans, **17**:13, **17**:14
Use taxes, **1**:7

V

Valuation allowance, **3**:13–16
Valuation requirements for charitable contributions, **16**:49
Value added tax (VAT), **1**:7
Value test, **9**:33
Voluntary revocation, **12**:9
Voting power test, **9**:33

W

W-2 wages, **5**:21
  DPAD and, **11**:18
  Form W-2, **16**:25
Wash sales, **7**:16–17
Water's edge election, **13**:28
Wherewithal to pay, **1**:30–31, **15**:7, **17**:40
Windfall income, **4**:5
Withdrawals, reporting partnership operating results, **11**:19
Work at home, crossing state lines, **13**:23
Work opportunity tax credit, **14**:7–8, **14**:14
  long-term family assistance recipient, **14**:8
Workers' compensation, **16**:34
Working agreement, **11**:2
Working condition fringes, **17**:14, **17**:16, **17**:20
Working Families Tax Relief Act of 2004, **16**:12, **16**:13
Worthless securities, **6**:6–7, **8**:8
  small business stock, **6**:6
Worthless stock, bankruptcy and, **8**:8
Writ of Certiorari, **2**:15

Y

Year of discovery, theft loss, **6**:8
Year of inclusion, **4**:7–13
  accounting methods, **4**:7–10
  special rules for accrual basis taxpayers, **4**:12–13
  special rules for cash basis taxpayers, **4**:10–12
  taxable year, **4**:7

AMT Formula for Individuals

Regular Taxable Income	
Plus or minus:	Adjustments
Plus:	Tax preferences
Equals:	Alternative minimum taxable income
Minus:	Exemption
Equals:	Alternative minimum tax base
Times:	26% and 28% graduated rates
Equals:	Tentative minimum tax before foreign tax credit
Minus:	Alternative minimum tax foreign tax credit
Equals:	Tentative minimum tax
Minus:	Regular income tax liability
Equals:	Alternative minimum tax (if amount is positive)

AMT Formula for Corporations

Regular Taxable Income before NOL Deduction	
Plus or minus:	Adjustments (except ACE adjustment)
Plus:	Tax preferences
Equals:	AMTI before ATNOL deduction and ACE adjustment
Plus or minus:	ACE adjustment
Equals:	Alternative minimum taxable income (AMTI) before ATNOL deduction
Minus:	ATNOL deduction (limited to 90% of AMTI before ATNOL deduction)
Equals:	Alternative minimum taxable income (AMTI)
Minus:	Exemption
Equals:	Alternative minimum tax base
Times:	20% rate
Equals:	Tentative AMT before AMT foreign tax credit
Minus:	AMT foreign tax credit
Equals:	Tentative minimum tax
Minus:	Regular income tax liability before credits minus regular foreign tax credit
Equals:	Alternative minimum tax (AMT) if positive

Tax Formula for Corporate Taxpayers

Income (broadly conceived)	$xxx,xxx
Less: Exclusions (income that is not subject to tax)	(xx,xxx)
Gross income	$xxx,xxx
Less: Certain business deductions	(xx,xxx)
Taxable income	$xxx,xxx
Federal income tax (see Tax Rate Schedule inside front cover of text)	$ xx,xxx
Less: Tax credits (including Federal income tax withheld and other prepayments of Federal income taxes)	(x,xxx)
Tax owed (or refund due)	$ xx,xxx

Tax Formula for Individuals

Income (broadly conceived)	$xx,xxx
Less: Exclusions	(x,xxx)
Gross income	$xx,xxx
Less: Deductions *for* adjusted gross income	(x,xxx)
Adjusted gross income	$xx,xxx
Less: The greater of— Total itemized deductions *or* standard deduction	(x,xxx)
Less: Personal and dependency exemptions	(x,xxx)
Taxable income	$xx,xxx
Tax on taxable income	$ x,xxx
Less: Tax credits (including Federal income tax withheld and other prepayments of Federal income taxes)	(xxx)
Tax due (or refund)	$ xxx

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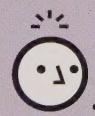
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